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Agricultural reform in Ukraine

Agriculture accounts for a significant share of Ukraine's GDP; it also plays an important social function, since the rural population almost entirely depends on it. However, despite its huge potential, the sector continues to suffer from inefficiency and non-competitiveness. These two factors point directly to the urgent need for reform in Ukraine's agriculture.

Reforms in the sector have been sluggish, and major problems still remain unresolved. While the problems are numerous and their nature is not unique to Ukraine, some of them need to be addressed first in order to ensure the success of the whole reform process. Crucial areas where urgent improvement is needed include state policy development and implementation, farm restructuring and land reform, and rural financing.

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Editors

FRANK BOSTYN (e-mail: frank.bostyn@ua.ac.be) is a professor of management at the University of Antwerp, and Chairperson of the Department of Management and Director of the MBA program at the University of Antwerp Management School (UAMS). Previously, he was a team leader of the EU-Tacis "Agriculture Policy Formulation Advisory Project", the EU-Tacis project "European Expertise Service – Agriculture", and the EU-Tacis project "European Expertise Service – Strengthening the Policy Formulation Process". In 1996, Prof. Bostyn was appointed as an International Co-ordinator of the Inter-Ministerial Commission for Agricultural Reform (now known as the Secretariat of the Presidential Commission for Agricultural Policy), by the Cabinet of Ministers of Ukraine.

ANDRIY BOYTSUN (e-mail: andriy.boytsun@ua.ac.be) is a doctoral student and research assistant at the University of Antwerp. Previously, he worked at the Permanent Secretariat of the Inter-Ministerial Commission for Agricultural Reform (now known as the Secretariat of the Presidential Commission for Agricultural Policy) in Kyiv. He also authored the "Agriculture" section in *Quarterly Predictions*, a survey publication of ICPS.

Authors of the research

STEFAN VON CRAMON-TAUBADEL is a professor of agricultural policy at the University of Göttingen, and a member of the German Advisory Group with the Ukrainian Government in Kyiv. He also serves as editor-in-chief of agricultural economics at the journal of the International Association of Agricultural Economists (IAAE).

CSABA CSAKI is a lead agricultural adviser in the World Bank's Environmentally and Socially Sustainable Development unit for Europe and Central Asia region, and a professor at Budapest Economics University, Hungary.

ZVI LERMAN is a professor at the Hebrew University of Jerusalem, currently on sabbatical as a fellow of the Woodrow Wilson International Centre in Washington, and consultant at the World Bank's Development Economics Research Group.

KONSTANTIN SIRIN is a research associate at the Institute of Agricultural Economics of the University of Göttingen. He was educated at Universität Konstanz (Germany), Wirtschaftsuniversität Wien (Austria), and the Kyiv National University of Economics.

LUDWIG STRIEWE is a research associate at the Institute of Agricultural Economics of the University of Göttingen, and a member of the German Advisory Group with the Ukrainian Government in Kyiv. He studied at the University of Kiel and the Wageningen Agricultural University (Netherlands), graduating in agriculture and obtaining a European Master's of Agricultural Economics.

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Introduction

Frank Bostyn and Andriy Boytsun

In Ukraine, agriculture represents almost 18% of GDP and even a greater share of country's total employment. It has an important social function, since the rural population (which makes up approximately 30% of Ukraine's total population) almost entirely depends on it. Furthermore, the performance of Ukraine's overall economy is largely dependent on the fortunes in the agricultural sector; and the GDP fall in recent years has been largely due to the decline in this sector. The contribution of agriculture to export revenues is in line with its part in the GDP, although it still remains weak compared to its potential.

It is generally observed that the agricultural sector in Ukraine has a lot of potential. Agro-climatic conditions are particularly favourable for grains, oilseeds, root and fibre crops, as well as for livestock and temperate fruits and vegetables. Ukraine has had relative cost advantages in crops such as wheat and sunflower, and could eventually achieve them for beef and pork production, as well. It is easier to analyse The potential of Ukraine's agricultural sector could be summarised by way of the following strengths-weaknesses analysis:

Table 1. Strengths and weaknesses of Ukraine's agriculture

Strengths	Weaknesses
General	
1. Abundant agricultural resources.	1. Insufficient humidity of 2/3 of the rich soils in the central and southern parts of the territory (less than 400 mm/year), and excessive humidity in the north and west of the country.
2. Rich soils: 70% of the world's black soils (chernozems), comprising 50% of the country's ploughed land.	2. Low productivity: crops are 30–50% less productive than in Western Europe, milk is productivity 3 times lower, and meat is productivity 30–50% lower in cattle and 4–5 times lower in hogs.
3. Favourable growing conditions for 90–120 days of the year.	3. Lack of a proper input base (chemicals, transport, machinery, etc.) for small and medium-sized producers.
4. Variety of climatic conditions.	4. Lack of experience and knowledge of most private producers regarding exports and any other commercial activities.
5. Geopolitical location: • Located between East and West; • Year-round access to the Black Sea.	
Labour	
1. Good traditions in agriculture (source of wheat, milk, sugar, oil, and milk for the Soviet Union, and the Russian Empire before that).	1. Lack of knowledge, tradition, experience, and education for profitable private farming; an acute need for management and marketing training.

Strengths	Weaknesses
2. Large rural population used to agricultural production. Substantial part (20–30%) of urban population is willing to be involved in agriculture.	2. Absence of an organisational background for adequate professional and interprofessional non-governmental farming associations at national and regional levels.
3. Large number of individual producers (subsidiary holdings).	3. Lack of appropriate living conditions hampering the return and settlement of the urban population in rural areas. Insufficient cultural, educational, or medical infrastructure.
Market	
1. Historical background: good opportunities and long-term relations with Russia and other former Soviet Union countries.	1. Excessive processing margin.
2. Opportunities in the Far and Middle East markets.	2. Presently severed links with the former Soviet Union partners at the official level, shrinkage of exports to Russia.
3. Relatively low cost of agricultural commodities, first of all vegetable oils and grains.	3. Absence of a trading infrastructure, especially for exports.
4. Low farmgate prices for meat and milk.	4. Quality grading inconsistent with international standards, which hampers foreign market entry.
	5. No price policy.
Infrastructure, institutions and management	
1. Gradual transition from command and control economics to more effective, self-organised free market management.	1. Lack of an appropriate infrastructure for inputs (chemicals, agricultural and transport machinery, etc.) for small and medium-sized agricultural producers.
2. Conversion to new ownership relations is underway. Land reform and farm restructuring speeded up in 1999 and 2000 by the re-elected President and the new reformist government.	2. Poor contract enforcement, due to the inexperienced and susceptible judiciary and faulty execution system.
	3. Management often oriented towards output, not demand and costs. Lack of long-term strategies.

Source: Adapted from F. Bostyn and C. Morand-Fehr, 1997: 28–29 and F. Bostyn, 1996: 4–5.

Despite the strengths of Ukrainian agriculture, its output has been falling in the past decade. In 1999, Ukraine's agriculture shrank to less than a half of its 1990 size. The decline has been due to both overall economic factors and to the lack of any new industry-specific policy, which has made agriculture the least reformed sector in Ukraine's economy.

Improvement in the rural economy is very much contingent on the success of agricultural reform, which must eventually lead to an effective agricultural sector. It is extremely important to secure the sustainable profitability of this sector, given its share in Ukraine's GDP.

It has always been popular to argue that Ukraine, like many leading Western countries, should provide massive government support and subsidies to agriculture. It is obvious, though, that an economy can provide such support only at the expense of its other—profitable—sectors. Therefore, this is possible when the share of the unprofitable sector in GDP is relatively small (like in the said Western countries), but the industry itself is very important for the economy. However, when an industry accounts for one-fifth of GDP, the objective should be to make it self-subsistent (i.e., not dependent on all kinds of government subsidies) and profitable.

In October 1994, the newly elected President, Leonid Kuchma, announced the main directions of agricultural reform policy, aimed at a faster transition to a free market in the agricultural sector. The beginning of the reform was quite successful, especially in terms of land reform. However, the reform stalled at a later stage; this was basically caused by two groups of factors—political and "technical". Since the political factors are discussed in the articles herein, below we shall briefly examine the "technical" factors that have stood in the way.

As a legacy of the former Soviet-era organisational structures, in Ukraine there has been a lack of co-ordination and strategic integration of policy measures, largely due to the existence of parallel monolithic structures, and also inherent over-specialisation. Hence, policy formulation has been rather weak, and decision-making agencies are still not well-equipped in terms of working methods, procedures, and expertise adapted to the new political and economic environment. The result is often a lack of coherence, sub-optimal use of policy instruments and resources, a lack of co-ordination, unclear responsibilities, and belated policy responses.

Accurate perception of the real problems in the Ukrainian agricultural sector has been dubious. The lack of experience with a market economy, and the legacy of the old system and way of thinking, still very much influence the way policymakers identify problems. Hence, already the starting point of the policy debate has often been wrong or poorly defined. Analysis of problems has tended to be even poorer. No significant tradition of policy analysis and strategic thinking, adequate for a market economy, yet exists. Since the executive branch of government was still poorly adapted to the new political and economic conditions (e.g., sectoral ministries were organised as instruments of an administered economy), analysis has been too often conducted in terms of administering the economy. In the case of the governmental agencies responsible for agriculture (the sectoral ministry and state committees), this was perhaps the most obvious. Hence, no wonder effective policy formulation procedures are still missing in Ukrainian agriculture, for the whole fabric of policymaking as a fundamental function of the executive is still emerging.

Finally, agricultural reform in Ukraine received a new impetus at the end of 1999, soon after the presidential elections, when on 3 December President Kuchma signed Decree No. 1529/99 "On immediate measures to accelerate reform of the agricultural sector of the economy". It was mostly focused on fostering farm restructuring by (i) reconfirming the right of CAE shareholders to withdraw their shares (land and property) from CAEs and prohibiting the restriction of this right by decision of meetings of CAE shareholders; (ii) allowing groups of owners to receive/lease adjoining land parcels to be used jointly;[1] (iii) simplifying the procedure for expanding subsidiary farms/plots; and (iv) recognis-

[1] Implementation of this regulation, however, is questionable, since the effective law does not describe how such groups of owners can obtain joint ownership of their land parcels, which is a necessary condition for entering into a lease agreement.

ing land share certificates as legal documents entitling their bearers to possess, use, and dispose of such shares. However, there is still some work to be done in this area, since important issues such as farms' debts, which prevent farms from restructuring, have remained unsettled.

The government has also shown its intention to refrain from participating in agricultural production by adopting a series of measures which tackle the issues of input supplies and rural credit.

Despite these positive changes, land reform, farm restructuring, and rural finance remain among the most important generic problems that need to be addressed to achieve progress in Ukrainian agriculture.

LAND REFORM—aimed at unrestricted private ownership and tradability of land—is crucial, since the overall objective of agricultural reform is to ensure the better performance of agriculture, i.e., to improve the efficiency of farms and of the sector as a whole. In these terms, the institution of private ownership of land is an indispensable condition to achieve this objective.

There are three major functions that private ownership generally fulfills in a market economy. First, it ensures that there are real owners of assets/resources (not only land, but also means of production)—unlike the case of collective or state ownership, where the resources are taken for granted. Thus, private ownership ensures the productive use of resources, which is an underlying condition for effective management. Second, it allows owners to use their assets as collateral. The fact of having collateral allows involving outside creditors in the production process, via their loans secured by that collateral. Third, the threat of losing their assets makes owners/managers refrain from risky decisions, and they manage their enterprises with the purpose of making (and maximising) profit. This, again, ensures the productive use of resources and efficient management; and if the management is not efficient, the enterprises will be taken over by new, efficient owners.

FARM RESTRUCTURING—aimed at improvement of farm performance (i.e., improved profitability and efficiency)—is thus dependent on the success of land reform, because it needs a new institutional basis to rest on. The results of farm restructuring in Ukraine have been limited, particularly due to the unresolved land issue. Restructuring of agricultural enterprises itself is crucial, since the new economic environment requires a significant adjustment of enterprises thereto (operation, management methods, marketing, and related areas)—a task they can hardly undertake on their own, especially after agriculture was so heavily regulated in the Soviet era.

The third unresolved issue, **RURAL FINANCING**, prevents farms from operating in a proper manner. Farms in Ukraine lack working capital, and have no feasible assets to pledge;[2] neither do they have a reputation that would help them obtain credits from lenders. Hence, agriculture has been unable to attract long-term financing or investment. The lack of creditworthiness of farms remains the major problem of farm financing. Stuck in these problems, farmers often are forced to forego potentially profitable investment projects, and most agricultural enterprises are constantly on the verge of bankruptcy,[3] even though the state has forgiven their debts to the government many times over.

These problems prevent potentially profitable agricultural production and related agricultural development. As becomes clear from the above discussion, these issues

[2] Land could be one of those assets, though.

[3] However, a moratorium on bankruptcy of agricultural enterprises was introduced. Such a policy action hampers the development of efficient ownership relations, and thus undermines the very economic foundation of agriculture.

must be the first to be addressed on Ukraine's agricultural policy agenda, since the rest of the reform is contingent on them. Unless they are addressed properly, little or no improvement can be achieved in agriculture overall. And unless they are addressed quickly, it may be very difficult to repair the consequences in the long run.

The major problems of Ukrainian agriculture are discussed in the first part of this issue of *Policy Studies*, while the second part concentrates on two sub-sectors in agribusiness—oilseeds and sugar.

Everyone familiar with Ukrainian agriculture will agree that both sectors are sensitive, but for different reasons. Oilseeds might have high potential, while the sugar sector is in deep trouble, with little hope for sustainable improvements.

The Ukrainian oilseed industry has been relatively successful and managed to attract significant foreign investment. This suggests that the sector is internationally competitive and that policy distortions that have discouraged investment in other areas of agriculture, such as grain production and processing, have had a less damaging effect on oilseeds.

However current, government policy is badly hampering the strengthening of the sector, which would allow Ukraine to tap on excellent export potentials. In particular, policymakers in Ukraine introduced an export duty on oilseeds. Such intervention is capable of eliminating any incentive for increased efficiency, and hence, the dynamic effects of this policy measure will be quite harmful for the international competitiveness of the oilseed industry.

The picture for sugar production is completely different: the Ukrainian sugar industry cannot withstand competition on the world market and, hence, the whole sector needs reworking.

From an economic point of view, the straightforward answer would be to fold the sector. The challenge remains huge, however, at the social and political level; the immediate social fall-out in terms of layoffs looms large. Hence, seemingly sound economic policies are confronted with the insurmountable challenge of making them politically acceptable. Pressure from within is high to keep sectors going artificially with heavy state intervention and subsidisation, but that kind of solution is not sustainable in the long term. Hence, there is a need for a more structural approach, focusing on long-term sustainability.

Agricultural strategy outline

FRANK BOSTYN

The slow pace of reforms in Ukrainian agriculture is mainly caused by the government's inability to develop and implement a sound reform strategy, aimed at ensuring long-term sustainability of the sector. The inability results from a number of factors, including inadequate capability to analyse policy requirements; lack of co-ordinated policy formulation and implementation; inadequate administrative structures; lack of clarity on effective leadership; the influence of those having a stake in halfway reforms; and the influence of conservative forces. When these crucial problems are resolved, the government will be ready to develop an agricultural reform strategy aimed at providing a proper macroeconomic and legal environment, effective markets, and further enterprise restructuring.

Main obstacles for reform in the agroindustrial complex

Success of agricultural reform is mainly determined by government ability to develop and implement a sound reform strategy. Still, many problems remain in this area, among which the most important are:

1. inadequate capability to analyse policy requirements;
2. lack of co-ordinated policy formulation and implementation;
3. inadequate administrative structures;
4. lack of clarity about effective leadership;
5. the influence of those having a stake in halfway reforms; and
6. the influence of conservative forces.

Inadequate capability to analyse policy requirements

Perception of the real problems is questionable. The lack of experience with a market economy, and the legacy of the old system and way of thinking, still very much influence the way policymakers and opinion leaders identify problems. Hence, already the starting point of the policy debate has often been wrong or poorly defined.

Analysis of the policy problems tends to be even poorer. The old paradigm of economic analysis still prevails, disregarding the complex functioning of a market economy. Analysis is too often made in terms of administering the economy (e.g., announcement of production objectives by the Ministry of Agriculture that are, in fact, planning instructions rather than estimates/expectations). No significant tradition of policy analysis and strategic thinking really exists.

Lack of co-ordinated policy formulation and implementation

The whole fabric of policymaking as a fundamental function of the government is still emerging in newly independent Ukraine. The learning process is, however, not systematic and not strategically thought out. This might, unfortunately, lead to missed opportunities.

A major factor influencing the situation is the fundamental lack of policy co-ordination, due to an unclear definition of powers and responsibilities among the multitude of governmental bodies in the sector. The 1996 Constitution of Ukraine took away some of the confusion over important issues like the legislative framework, legislative initiative, policy formulation, and executive control. However, the concrete operation of governmental bodies under the terms of the new constitution is still in its formative phase. Moreover, the administrative structure of the executive is still poorly adapted to the new political and economic conditions.

This often results in a proliferation of *ad hoc* policy measures, not integrated in a global approach and more often remaining purely on paper. This is a consequence of a rather formalistic and very bureaucratic policy formulation process, typically driven by *post-hoc* responses, i.e., problems are identified after analysis of the results of the previous period. Typically, the main reason for identifying problems and putting them on the agenda has been to sanction those presumed responsible.

The accumulation of paper resolutions as a response to conditionalities put forward by international financial institutions and donors, remaining without real implementation, has been trying the patience of these bodies, with the Ukrainian government increasing their frustration. Out of this has grown the preference of some donors to use their TA projects directly to put pressure on the government, and also to foster their own political and commercial interests. These are very unfortunate responses, being quite counter-productive in terms of strengthening policy formulation for sound reform.

Inadequate administrative structures

The administrative structure of the Ukrainian executive is still poorly adapted to the new political and economic conditions. The Ministry of Agricultural Policy is still wholly organised as the tool of an administrated economy, and lacks the essential functions of such a ministry within the context of a market economy. The double structure with the Cabinet of Ministers and sectoral ministries complicates policy formulation and implementation. This is mainly a legacy of the Soviet past, typified by parallel monolithic structures and inherent over-specialisation.

We can observe growing frustration, at a high level, with the functioning and the results of the administrative structures of government. This can and does, in some cases, induce an increasing awareness of the need to fundamentally reorganise these structures and a greater openness to external advice on related matters. However, ministers and the government as a whole often remain relatively powerless, even if their reform intentions and enthusiasm might be pronounced. The stake of the unreformed administration in a status quo might even lead to opposition to the government and a de facto split in the executive branch of power, as is illustrated in the refusal to implement policy decisions, or sabotage of their implementation.

The monolithic structures in Ukraine, corresponding to vast economic sectors, lead to a close marriage between these structures and specific economic/political interests, inducing a very strong tendency towards corporatism and narrow-minded sectoral protectionism. This trend is clearly visible in the AIC, and blocks effective reform and structural reform, so badly needed to really develop the agricultural potential of the country to the benefit of all of the population. Illustrations of this are countless: the absence of effective farm restructuring, the blockage of sound or radical land reform, the disastrous special privatisation law for the agro-processing sector, claims for protectionism, etc.

Lack of clarity about effective leadership

In periods of dramatic change affecting the economic system, the political system, and the establishment of a newly independent state, institutional arrangements are often blurred, and within such a context social and political tensions and indecisiveness might arise. Effective leadership, socially legitimated, can orient the transition period in a more effective direction. However, Ukraine still appears to be a victim of unproductive political disputes and antagonism.

At the operational level of governance, this is often exacerbated by the following shortcomings: (a) lack of authority or delegation of responsibility; (b) weakness in introducing a global vision; and (c) poor communication skills, or even neglect of communication. The three are, of course, interlinked.

In such a context, it is not surprising that efforts to overcome the weaknesses of the administration are very scattered and only pursued in a very hesitant way. The alternatives themselves are influenced by the old traditions, which entails further constraints. Typically, a minister would rely on outside advice from academic institutions. Traditionally, policy formulation has been heavily influenced by the scientific or academic community, but the slow pace of self-renovation of these bodies led to the persistence of outdated ways of problem formulation and analysis. Furthermore, the ad hoc consultation and involvement of these professionals as a complementary activity to their main job, does not lead to serious attempts for strategic integration, but emphasises the traditional tendency towards a partial approach and compartmentalisation.

Moreover, the new political system has not yet matured, and political fault lines tend to get institutionalised, especially in an antagonism between the legislative and the executive branches of power. As a result, the normal functioning of a parliamentary democracy is still very doubtful; or at least, in such circumstances, this political system delivers poor policymaking and consensus-building results.

The influence of those having a stake in halfway reforms

Within the current institutional and economic context, entrepreneurship is, not surprisingly, weak. Incentives are lacking, risks are extremely high, and needed resources are difficult to gather or attract. Persistent administrative interventions hamper initiatives and often discourage sincere entrepreneurship. Consequently, corruption, illegal profit-taking, and collusion between business and administration gain field and give way to the emergence of groups having an interest in maintaining half-way economic reforms.

The influence of conservative forces

In Ukraine, supporters of the orthodox Communist concepts (e.g., collective land ownership) still influence public opinion. Some of them believe sincerely in the efficiency of state administration of the economy, while the majority seeks economic advantages from maintaining current structures. Even today, this latter group is striving, at the legislative and administrative level, to establish preferences and privileges which allow them to secure control over enterprises and avoid market competition. Not less important for them is to take a lion's share of real assets during a privatisation deal. Large portions of the rural population—some for fear of losing their job and the social benefits still delivered by *kolkhozes*, some for lack of information, and some for their inability to independently adjust to a new environment—ignorantly support the conservatives.

Results for the Ukrainian agricultural sector

Partially as a result of these problems at the stage of developing a reform strategy, the Ukrainian agricultural sector and agro-industry are still in deep crisis. Agricultural output keeps on declining, and the processing sector is near total collapse. The social and economic importance of the so-called agro-industrial complex for Ukraine entails that these economic problems risk triggering a profound social crisis in rural areas.

The potentials of agriculture and the rural sector in general might be very important; however, the right economic and institutional conditions are not really in place to let them fully develop. Ill-conceived agricultural policies account for a large part of the decline in Ukrainian agricultural output. The right incentives for management and the workforce are not in place; hence, low levels of factor productivity. Monopolistic and inefficient distribution systems for agricultural inputs and outputs, resulting from the planned economy, are still playing an decisive role. Implicit influence and control over prices through contracts and state orders has continued. This has all resulted in pressure on farms to sell at low prices as a condition for access to a supply of otherwise hard-to-get inputs and credits. Hence, international prices are poorly transmitted to the domestic market, and the agricultural terms of trade have undergone substantial erosion.

Poorly conceived privatisation schemes have not solved corporate governance problems; nor have they triggered real enterprise restructuring and structural adjustment. Efficiency remains low in agriculture and agro-processing, as well as in input and output markets. Renewal of the technical and managerial base, with inflow of investment capital, is almost nonexistent. Farming is hampered in its development and restructuring by the lack of secure and transferable land use rights, land mobility, documented property rights, sound legal frameworks for land lease, land markets and land as collateral, access to financial markets, legal framework for organisational forms of entrepreneurship, and—last but not least—a fundamental lack of information on the rights and responsibilities of the rural population.

Results for the national economy

The lack of effective structural adjustment in the AIC and in other sectors of the economy of Ukraine has already started to erode the previously accomplished currency reform and monetary stabilisation. Macroeconomic stabilisation can be sustainable if it is underpinned by a sound (microeconomic) structure; but this is not the case in Ukraine. Macroeconomic stabilisation—in fact, only monetary stability—has been stretched by purely monetary policy measures and international financial support, but is now at the verge of collapse. Radical and effective structural adjustment is imperative and urgently needed, in order not to put relative monetary stability at risk. The chances of further economic collapse are still real, and the main explanation will be the de facto lack of economic reforms and structural adjustment. This would catapult Ukraine in an even deeper economic and social crisis. It would then take many years to reverse the situation, entailing real losses of wealth and real suffering for the population.

Preconditions for an effective reform strategy

From the above, it can be learnt that there are some preconditions for an effective reform strategy. Economic and agricultural reform is about policy, not merely about economics. Ideally, economic insights should drive strategy development and the reform process, but politics is about making it possible. Politics is the art of the possible. This should, however, not be interpreted in a fatalistic way, but should rather be perceived in a pro-active way, allowing strategic and tactical moves with the aim of reaching the final objectives.

It is clear that in order to succeed with reforms, the AIC administrative structure should be tackled right away and in a radical way. However, the functional reorientation of the ministry should not be seen as an isolated act, but should be incorporated in a global strategy for developing effective governance structures in Ukraine, adapted to a market economy, that would be instrumental and not obstructive to the policy set by democratically elected bodies. The basic principle should be that there are sufficient checks and balances in the new governance structure to avoid the problem of moral hazard in the administration and the development of disproportional power centres out of democratic control, as we have now with some corporatist and monolithic structures.

The best way to look at the issue is through the principal–agent perspective. The administration has to act on behalf of the government. However, the government is democratically accountable and changes regularly, while the administration stays in place. The ministry is also supposed to collect the information on which the government sets its policy. This might lead to a situation where the administration sets its own agenda or wants to hide its poor performance by willingly misinforming the government. Such a tendency is more probable, and also quite dangerous, when the administration comes under the influence (or even slight pressure) of economic interest groups. The temptation for collusion can be very important, as the rents can be huge. Such a situation is called corruption.

It is important that the government have enough control over the administration. Even better is to have proper structures, which prevent the emergence and development of principal–agent problems. In any case, sectoral collusion should be absolutely tackled and prevented; otherwise the government can no longer be in charge. This condition is, however, not fully fulfilled in Ukraine. The dominance of the monolithic organisation of political governance structures is the single most important cause for this problem. Therefore, it is absolutely imperative to break these structures right away.

Furthermore, the reform of the administrative structure is not only a matter of tackling the principal–agent problem, but of sound governance and division of political responsibilities. Here, the major principles should be the following:

- The agricultural sector should not be treated differently from any other economic sector. Should one do this anyway, then it would be at the expense of other sectors, and, hence, finally at the expense of the well-being of the population.
- As far as there are specific concerns for agriculture as a primary sector, this can only be the case for the activities directly linked to nature (land, weather/climate conditions), i.e., farming versus processing.
- Following the first two principles, a reorganised ministry of agriculture should only be responsible for the farming sector and the market for primary agricul-

tural products; the responsibility for the agro-processing and food industries should be transferred to the ministry of economy.

- The educational system of the AIC (universities, colleges, secondary schools) should be transferred to the ministry of education. Food control, health regulations regarding agricultural products, etc., should become the prerogative of the ministry of health care.

- Land title registration and land use regulation are not agricultural policy matters: they are of a broader nature, regarding the physical, infrastructural, and legal (property rights) organisation of the country. Consequently, title registration is a legal matter regarding the securing of property rights and should, hence, be subordinated to the ministry of justice or a separate body, integrating title registration of all real estate (unified cadastre). Hence, the State Committee for Land Resources can be abolished.

- There is no need to have a complementary Department for Agriculture at the Cabinet of Ministers level.

Finally, the remaining preconditions for developing a viable reform strategy include effective leadership and neutralisation of the influence of those having a stake in halfway reforms and of the conservative forces. These are purely political factors.

Building blocks for an agricultural strategy

Once the obstacles discussed above are adequately dealt with and the preconditions are met, a sound reform strategy can be successfully implemented. This strategy, as a conceptual plan with a broad and detailed action scheme, should emerge from the Ukrainian policy formulation process itself, and should not be "imported" by granting one or another blueprint by outside advisers the status of an official plan by decree. That way, it will simply not work.

Elements of the reform strategy should be carefully elaborated, taking into account their costs, effectiveness and implementability, the risks of effective obstruction and misuse of policy measures for group interests, proper timing, co-ordination and consistency of the measures, etc. In other words, the process should be driven by realism and pragmatism.

To be successful, the plan must be broadly accepted by and committed to by the administrative/governance structures which have to implement it. This means that it is imperative to engage these structures already at the formative stage. To bring this about can be one of the major tasks of the Secretariat of the Presidential Commission for Agricultural Policy. The Secretariat has the mandate to introduce and activate policymaking mechanisms for proper preparation of policy proposals, estimating the costs of alternative proposals, ensuring their critical evaluation through consultation and debate, and reaching and recording decisions and monitoring their implementation. This entails the development of an effective capacity to facilitate consultation, and to co-ordinate proposals among ministries before they are submitted for final approval.

Taking into account the very nature of sectoral reform strategy in a transition economy, the basic philosophy of it should be as follows: the overall objective is to increase the wealth of the nation and its population in a sustainable way. Therefore, it is necessary to improve the economic efficiency of the sector. The right way to do this in a market economy is to create the proper general environment that can induce increased efficiency at the microeconomic (enterprise) level. Hence, the government should aim at ensuring:

- a proper macroeconomic and legal environment;
- effective markets; and
- further enterprise restructuring.

While the first objective (i.e., developing a proper macroeconomic and legal environment) refers to the whole economic system and, hence, is beyond the scope of our analysis, we will briefly discuss the remaining sector-specific objectives. Although the logical framework of a reform strategy presented below is not intended to be complete, it might be helpful to structure discussions and a workplan to come to a detailed strategy.

Developing effective markets

The role of effective markets is paramount to reach an optimal situation of economic efficiency, and hence of sustainable development and welfare. The functioning of the market should stimulate sustainable economic activities, otherwise longer-term social and economic costs might turn out to be higher than the value created, thus leading to an overall negative value-added. Therefore, interventions going against this sustainability criteria, and non-market ad hoc interventions, should be avoided.

On the other hand, it is sometimes argued that interventions might be needed to guarantee or to foster sustainability. Since in agriculture output decisions cannot be made unconditionally because of the dependence on nature, short-term viability of economic activities in agricultural production might be critical at certain periods of time, while longer-term profitability and sustainability are not questioned. This argument is then used to justify fine-tuning any interventions to stabilise the market.

The working of markets in agriculture is intrinsically linked with the two other crucial elements for the normal functioning of a market economy—individual freedom and proper institutions (including legislation).[4] For example, the institution of private property not only provides proper incentives, but also imposes responsibility. Sound legislation, the rule of law, and effective enforcement of the law set rules of the game that are equal for everybody.

A sound agricultural market policy in Ukraine should comprise the following crucial elements.

IN MARKETS FOR PRODUCTION FACTORS AND OTHER INPUTS:

- Conduct radical land reform (accelerated and effective privatisation of land, including abolishment of the legal concept of "collective property", establishment of effective land markets, etc.);
- Liberalise the rural labour market;
- Improve access to credit;
- Facilitate access to machinery-service centres for private farmers.

IN MARKETS FOR AGRICULTURAL COMMODITIES:

- Improve access to commodities markets;
- Ensure market transparency (market information, standardisation, etc.);
- Demonopolise the markets;
- Develop commodity exchange and farmers' markets.

Effective farm restructuring

Market policy is an essential element of the reform policy within the context of a transition economy; however, it is not the only aspect. A genuine restructuring policy (i.e., fostering and accelerating enterprise re-

[4] Institutions should be interpreted here not as organisations but in the sociological meaning of the word: institutionalised patterns of behaviour.

structuring) is crucial as well. While market policy aims at strengthening the workings of the market, restructuring policy focuses on the management and adaptation of the economic activities of the enterprises, and their interaction with the market and the emerging industrial organisation (especially the market structure). Integration of both market and restructuring policies should facilitate structural adjustment and, hence, economic efficiency and performance of the Ukrainian agricultural sector.

A sound farm enterprise restructuring policy should include measures aimed at:

- effective privatisation and improving of corporate governance;
- enhancing management skills (consulting centres, professional organisations, and extension services);
- transitional measures:
  - debt restructuring;
  - social relief measures; transferring social services and social security obligations from agricultural enterprises to local authorities;
  - reconversion and retraining of labour;
  - regional development;
- implementation of effective bankruptcy procedures.

Farm restructuring and land reform in Ukraine: Policies to revive the agricultural sector

CSABA CSAKI AND ZVI LERMAN

In Ukraine, land reform has mostly been limited to transforming state ownership into collective ownership, and no profound farm restructuring has yet taken place. There is no real development of a land market, except for leasing. The weak reforms have failed to radically change the traditional collective organisation of Ukrainian farms. Break-up of large farms has been very limited, as has been the case with internal restructuring. Hence, it should not be a surprise that the transition process is not delivering in terms of increased profitability and efficiency.

At the same time, a general recovery of agriculture will also depend upon the implementation of basic policy measures aimed at: relaxation of inflexible bureaucratic procedures; introduction of hard budget constraints and imposition of strict financial discipline on farm enterprises; recovery of the agro-processing industry; development of competitive factor markets; liberalisation of external trade; and effective restructuring of farm enterprises.

March 2000 marked nine years since the launch of the land reform process in Ukraine and the beginning of attempts to transform its agriculture into a more efficient and productive system based on market principles and private ownership. In addition to such key elements as land reform and restructuring of traditional collective and state farms (*kolkhozes*), the sectoral reform agenda includes liberalisation of the market environment, privatisation of agro-processing and trade, and the creation of a new institutional framework for agriculture.

Some accomplishments have been made in each particular area of the reform agenda, but progress has been far from smooth and comprehensive. Agricultural reforms have been obstructed by the continuing struggle between liberal and conservative forces since the declaration of Ukraine's independence. Caught between these inner tensions, the government has been unable to implement the required policies or properly address key reform issues.

Status of land reform and farm restructuring

A significant accomplishment of land reform after 1991 was the transfer of state land to collective ownership. The share of the state in agricultural land dropped from 100% before 1991 to about 30% in early 2000. Farm restructuring, however, has only been "skin deep", merely "changing the sign on the door" in many cases, with minimal changes behind the formally new faзade of collective agricultural enterprises (CAEs)—or even their legal successors, for that matter.

The Government of Ukraine realised that the inadequate progress with farm restructuring is a major obstacle to productivity and efficiency improvements in agriculture. The presidential decree "On immediate measures to accelerate reform of the agricultural sector of the economy" dated 3 December 1999 was intended to remedy the unsatisfactory situation. Pursuant to the decree, collective ownership was abolished; the former state-owned *kolkhozes*, now collective-owned agricultural enterprises, are currently in the process of being again reorganised—into joint-stock companies, limited-liability associations, co-operatives, and private/family farms.[5] It was greeted with euphoria by supporters of agricultural reform and with virulent criticism by its opponents, although as a matter of fact it is largely a reiteration of long-established principles that have actively guided the process of land reform and farm restructuring in Ukraine since the beginning.

There is considerable diversity among the restructured farm enterprises in Ukraine, and where a new generation of farm managers has come in, there are often innovative approaches to internal organisation and operations management. On the whole, however, the farm restructuring efforts so far have failed to radically change the entrenched collective organisation of Ukrainian farms. As a result, these efforts have failed to produce improved performance and have not led to significant breakthroughs in the transformation of Ukrainian agriculture.

[5] The information in this paper generally predates the abovementioned decree.

Limited break-up of large farms

During the 1990s, agricultural enterprises changed their registered legal form, from *kolkhozes* to CAEs, and took over the ownership of land from the state. Later, spurred particularly by the abovementioned presidential decree, the farm enterprises moved from collective to private ownership, distributing land shares and asset shares to their individual members (in the form of paper certificates of entitlement, most often without physical demarcation of land or allocation of assets to individuals). Yet, their internal structure remains largely that of the former collective, with very few instances of determined or creative efforts to reorganise the farm enterprises into smaller, functionally independent units.

Even in international donor projects, which are run by experienced market-oriented managers and are intended to provide training ground for farm restructuring on a national scale, farms are being restructured on a predominantly one-to-one scale. Among the 300 farm enterprises having participated in the Ronco/USAID farm restructuring project in Ukraine, 90% have reorganised into a single legal entity, another 8% have divided into two legal entities, and only 2% have split into more than two legal entities. The (much smaller) IFC project managed to produce a somewhat higher proportion of large farm break-ups: here, the 40 parent farms split on average into 2 successor enterprises each (Table 1). Overall, however, we observe a limited break-up of large farms, and the restructured entities are still much larger, and therefore much less manageable, than typical farms in market economies.

The creation of new legal or corporate entities may be accompanied by the emergence of clusters of private/family farms (*fermy* in Ukrainian). In the international donor projects, 350 base farms have produced more than 2,500 private/family farms, based on the land and assets withdrawn by shareowners from the former CAEs (Table 1). This process contributes to the overall diversification of farm structures in Ukraine, and to a certain downsizing of the large farm enterprises.

Table 1. Break-up statistics on large farms in international donor projects in Ukraine

	IFC	Ronco/USAID	All projects
Parent farms (restructured)	47	304	351
Successor farms			
Enterprises	102	354	456
Private/family farms	253	2,390	2,643
Average number of successor enterprises per parent farm	2.2	1.2	1.3
Average number of private/family farms per parent farm	5.4	7.9	7.5

Source: Interviews with managers of international donor projects in Kiev.

Limited internal restructuring

Formal reorganisation, involving a change of legal registration and distribution of land shares and asset shares to individuals, is a prerequisite for the internal regrouping of productive resources in entities wishing to more closely attune themselves to market operations. Unfortunately, in Ukraine (as in the rest of the former Soviet Union), formal reorganisation of farm enterprises has not been accompanied by any meaningful internal restructuring. In a 1998 World Bank study, 70% of farms reported that they retained a central management body patterned on the former collective farms; only 30% reported greater shifts of responsibility to autonomously operating functional subdivisions.

However limited, restructuring has produced a definite favourable impact on labour relations and worker behaviour in the reorganised farms. Managers of reorganised farm enterprises give a much more positive assessment of the behavioural patterns of their workers than managers of non-reorganised farms. Significant deterioration of basic behavioural variables of farm workers is reported much more frequently by managers of non-reorganised farms than by managers of reorganised farms (Chart 1).

Chart 1. Negative evaluation of worker behaviour (deterioration of each behavioural variable)

Source: World Bank farm survey, October–December 1998.

Managers of reorganised farm enterprises believe in what they are doing; nearly 50% are convinced that the situation at their farms will improve as a result of reorganisation. Managers of non-reorganised farms are much more pessimistic on this point, and most expect their situations to deteriorate or, at best, remain unchanged.

Limited improvements in profitability and efficiency

Because of the lack of meaningful internal restructuring, Ukrainian farm enterprises have not made significant labour force adjustments, and the reorganised farms continue to employ roughly the same number of workers per hectare of land as before the reforms. Lack of this labour adjustment depresses profits, which in turn prevents the inflow of new investments. Because of the reluctance to shed excess labour, and the shortage of investment funds, restructuring has not led to breakthroughs in productivity or efficiency improvements.

Table 2 presents a comparison of the sales margins at reorganised and non-reorganised farms for 1997 and the third quarter of 1998. The margins are all negative, because the farms predominantly reported losses for these periods. The non-reorganised farms, however, had more negative profit margins (higher loss rates) than the reorganised farms both in 1997 and in 1998.

Table 2. Margins of sales: 1997 and 1998

percent of sales

	1997		1998 (Q3)	
	Number of farms	Sales margin	Number of farms	Sales margin
Non-reorganised farms	9	−53	8	−34
Reorganised farms	76	−25	73	−21

Source: World Bank farm survey, October–December 1998.

Reorganised farms also appear to be more efficient than non-restructured farms when efficiency is measured by the relationship among all inputs employed and all outputs produced. Regression estimates indicate that reorganised farms generate 40% more sales on average at each level of resource use than non-reorganised farms (the relevant resources include land, labour, livestock, and purchased farm inputs such as fertilisers, chemicals, and fuel).

Table 3. Median yields in farms of different categories

kg/ha for crop products; kg/cow/year for milk

	Reorganised farms	Non-reorganised farms	Private/family farms
Wheat	3,000	2,800	2,500
Vegetables	8,400	7,300	5,000
Potatoes	7,300	7,200	14,000
Sugar beets	15,600	12,400	27,000
Sunflower	1,100	1,400	1,200
Milk	1,850	1,500	3,500

Source: World Bank farm survey, October-December 1998.

Crop yields, as a measure of partial productivity of land, show a mixed picture across farms of different categories, including non-restructured collectives, restructured corporate farms, and private/family farms (Table 3). Overall, it is impossible to state at this stage that the productivity of land in reorganised enterprises is significantly higher than in non-reorganised ones, or that it is higher in individual farms than in enterprises.

A clearer restructuring effect is observed in the productivity of livestock (Table 3). Milk yields are much higher for individual farms than for enterprises; also, they tend to be somewhat higher for reorganised enterprises than for non-reorganised ones.

Land market limited to leasing

One specific level where significant changes are being observed is that of leasing relations. Land leasing has two different connotations in Ukraine. In addition to conventional leasing, which implies transfer of use rights to a specific plot of land for a specific term, leasing may also involve transfer of land shares from individual shareholders to farm enterprises or other individuals. Currently this is the dominant form of land leasing in Ukraine, although the practice of leasing physical plots is growing.

Leasing of land shares is a paper transaction that does not entail specific, properly demarcated plots of land. A farm enterprise, by leasing land shares from individual shareholders, simply assumes the legal right for using the area of land represented by the sum total of the leased land shares—land that has always been cultivated by that farm enterprise and is in effect recorded as a kind of privatised collective property on its books. A private farmer leasing land shares from other individuals has to negotiate the allocation of specific land plots with the local farm enterprise, which acts as an administrator and guardian of all undistributed farm land.

Leasing of land shares by individuals to enterprises is being formalised on an increasing scale through legal contracts that specify the terms of the lease and spell out the distributions (in cash or in kind) that the shareholder can expect from the lessor.

However, the end result in most cases merely ensures the survival of the traditional large farm enterprise, under its traditional centralised management: the shareholders tend to lease their land shares to their farm enterprise, and the manager of the former collective continues to control most of the original land through a formally restructured successor entity. This is perhaps an unavoidable outcome of the specific methodology prescribed by Ukrainian legislation and advocated by international donors: much emphasis is given to the technical stages of initial distribution of land shares and too little attention is paid to the substantive stages of regrouping of shareholders in smaller market-oriented units.

Buying and selling of farmland is virtually nonexistent in Ukraine, primarily because of the continuing legal moratorium on such transactions. Yet transactions in land shares among individuals and between individuals and enterprises are legally allowed, providing a working mechanism for adjustment of farm sizes.

As throughout the rest of the Europe and Central Asia region, farms are growing mainly by leasing, not by accumulation of private land through purchase transactions. According to a World Bank farm survey conducted in October–December 1998, private/family farmers in Ukraine have increased their limited holdings from 25 hectares to 60 hectares, on average, by leasing land. Some 45% of private/family farmers in the study report that they lease land; moreover, 20% report that they lease land from private individuals—a phenomenon never observed previously. Although there is no information on how much land private farmers lease through land shares, and how much in the form of physical plots, it is clear that the state is no longer the sole source of leased land in Ukraine.

Some enterprising individuals lease large blocks of land shares from former collective members (both active workers and pensioners), thus competing as lessors with the former collective farms. In this way they accumulate enough land for an individually operated farm of viable commercial size. In the present survey, such individual leaseholder farms (generally registered as legal entities) control on average 1,800 hectares, compared with 40 hectares for the conventional private/family farm in Ukraine. The number of shares actually used by the large single-founder farms is thus substantially greater than the number of shares contributed just by the founders: in the survey, these farms employ 60 land shares per founder, while the multi-founder farms (created by over 50 founders) employ basically one share per founder (see Table 4).

*Table 4. Single-founder and multi-founder farms**

Type of farm	Percent of farms in the sample	Average size, ha	Total number of shares used per founder	Percent of share-owners actively employed on farm
Single-founder farms	20	1,800	60	50
Multi-founder farms*	80	3,000	1.1	52

** more than 50 founders; most farms in the single-founder category have 1–2 founders.*

Source: World Bank farm survey, October–December 1998.

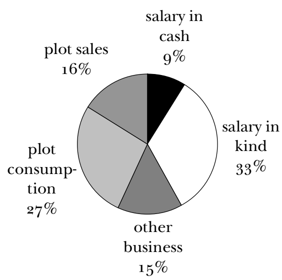
Contrary to earlier concerns, the individual leasing practice has not resulted in massive rural unemployment. The large individual leaseholders employ on their farms the same proportion of shareowners as the corporate farm enterprises: about half the shareholders are actively employed, while the remaining half are pensioners and other passive players (Table 4).

Differences between individual leasehold farms and corporate successors of former collectives will begin to be felt to the extent that the founders of large leasehold farms indeed behave as owner-operators and not as managers of assets entrusted to their care by former employees. Without a real ownership-driven change in incentives, the large leasehold farms may potentially deteriorate into the same mould as the former collectives.

Household plots remain the basis for individual agricultural activity

Household plots continue to maintain their critically important role for rural families. Household plot production accounts for nearly 45% of rural family income (product sales plus value of own production consumed; Chart 2), and begins to exceed the share of salaries (in cash and in kind) in family income. Household farming appears to be developing beyond the traditional subsistence mode: 60% of households in the 1998 survey report sales of farm products from household plots, and these households sell, on average, about half of their output. This naturally focuses the attention on the need for the development of marketing channels accessible to small individual producers, not only to the traditional large farms.

Chart 2. Structure of family income



Source: World Bank farm survey, October–December 1998.

The December 1999 presidential decree reinforced the possibility for individuals to withdraw their land shares from the former collective in physical form, with the purpose of augmenting their household plot. Contrary to previous practice, this no longer requires registration as a legal entity. Land withdrawn from the collective can now be cultivated by physical persons without registering officially as private farmers. This certainly constitutes a significant relaxation of the bureaucratic procedures that may have deterred potential farmers during the 1990s.

Policy measures for agricultural recovery

While farm restructuring generally has the potential for improving productivity and efficiency of agriculture, the accomplishments in Ukraine have been very modest. The major reason for this is that the overall economic and policy environment has not improved—and so, quite to the contrary, it has remained the major impediment to creating market-based agricultural enterprises. Additionally, the continuing decline in the overall economy and the lack of recovery in the non-agricultural parts of the rural sector have further limited the scope of any meaningful restructuring in the farming sector.

Comparative analysis of all European and Central Asian countries suggests that genuine macro-economic and political reforms, combined with overall economic recovery, are the driving forces for reform and economic recovery in the agricultural sector. Countries in the advanced stages of overall economic reforms, with healthy GDP growth, also show respectable agricultural performance. General economic recovery is closely correlated with market-oriented policy and institutional reforms. Thus, it is hard to expect significant recovery in Ukrainian agriculture, despite its restructuring efforts, as long as economic decline continues and as long as policy and institutional reforms remain sluggish.

Prospects for the revival of Ukrainian agriculture will largely be determined by the government's willingness to adopt a number of basic policy measures, aimed at:

- relaxation of inflexible bureaucratic procedures inherited from the command-administrative regime;
- introduction of hard budget constraints on farm enterprises (to be implemented in conjunction with a comprehensive program of old debt restructuring and a tangible threat of bankruptcy proceedings for farms that default on new debt);
- recovery of the agro-processing industry;
- development of competitive factor markets;
- liberalisation of external trade;
- effective restructuring of farm enterprises;
- development of alternative employment opportunities in rural areas to allow

shedding of agricultural labour as a prerequisite for productivity improvement;

- speedy resolution of the impasse in the maintenance and development of rural social infrastructure, through allocation of necessary budgets to local governments.

Let us discuss some of the relevant policy areas in more detail.

Recovery of agro-processing industry

Recovery of agro-processing needs to be facilitated by creating a secondary market for enterprise shares and a conducive climate for direct foreign investment. Formally, agro-industrial privatisation has proceeded reasonably well. The number of agro-industrial enterprises privatised to the extent of 70% or more increased from 2,200 in 1997 to 3,900 in 1998, out of a total of 4,800. Demonopolisation of the agro-industrial sector is being aggressively pursued by the Ukrainian Anti-Monopoly Committee, which has broken up more than 60% of the monopolies in the sector.

However, privatisation based on ownership by managers, workers, and raw-material suppliers has failed to produce more efficient agro-processors. Most agro-processing in Ukraine still operates with weak corporate governance, low levels of capacity utilisation, and outdated equipment. As a result, it cannot produce quality products, and its output remains uncompetitive even in domestic markets. The level of foreign investment is minimal, which prevents technological upgrading.

Development of competitive factor markets

Open and competitive factor markets need to be created in the sector, including a market for agricultural land.

Shortly after independence, a moratorium was placed on the sale of agricultural land, even if privately owned. The Ukrainian government argues that various decrees and normative acts since then have reduced the applicability of the moratorium only to the land allocated for free to individual smallholders by local municipalities. The parliament, however, continues to declare that there is a moratorium on the sale of land.

The government has responded by promulgating joint normative acts of the State Committee on Land Reform and the Ministry of Justice: (a) give the right to two or more members of a farm enterprise to withdraw with adjacent land plots; (b) limit to three months the time within which a farm enterprise has to give its consent to the withdrawal of land plots requested by one or more members; and (c) limit to one year the time within which exiting members must be given actual possession of their land plot. Further actions are needed to facilitate the emergence of a land market, including the creation of a uniform cadastre system. The revision of the law on land cadastre is an essential precondition for land market development in Ukraine.

Liberalisation of external trade

External trade liberalisation needs to be continued. In 1995 and early 1996, the government appeared to be committed to refraining from intervention in agricultural import and export markets (e.g., imposition of import and export quotas, export taxes, or export registration requirements). However, by mid-1996, the parliament had imposed duties on the export of live animals and hides. Also, in October 1997, it adopted the Law "On the regulation of agricultural product imports", which established quotas on the import of certain categories of live animals and fresh, refrigerated, and frozen meat. This law increased the protection of the agro-industrial sector from about 21% to almost 30%.

Partly as a result of these measures, agricultural sector imports fell by 11% in 1997. In 1998, the government managed to convince the parliament to grant exemptions for the exports of pelts, which are processed abroad and re-imported as semi-finished goods. With this measure, the negative impact of the export taxes on primary agricultural producers has been limited. Unfortunately, in 1999, export taxes were introduced on sunflower seeds and there has been increased pressure to introduce quotas and further restrictions on imports. These measures represent a departure from the initial course of foreign trade liberalisation.

Effective restructuring of farm enterprises

Finally, Ukrainian farm restructuring must proceed on a wider scale, with genuine farm privatisation and improvement in corporate governance. The management of large farms has changed little, with no rewards for efficient use of capital and higher labour productivity. In 1998, 88% of large farms reported losses. Most of the large farms have a significant amount of accumulated debts, and the government must develop effective strategies to remove the debt burden as part of the process of farm restructuring, and introduction of hard budget constraints for the future.

After eight years of reforms, only 15% of agricultural land in Ukraine is cultivated by individuals (private/family farms and household plots), and most Ukrainian agriculture still remains essentially collectivised, despite the diversity of organisational forms that have emerged since 1992. Moreover, the growth of private/family farming has slowed considerably since 1994, and the number of private/family farms appears to have stagnated (at least temporarily) at 38,000, with two percent of the agricultural land and about the same share of agricultural output.

Hence, the continuation of farm and agro-processing privatisation, improvement of corporate governance, and facilitation of private investment and credit to farms and agro-processors should be the main components of the policy framework for reviving Ukraine's agriculture. This agenda, if implemented, will encourage domestic and foreign investors to make the necessary capital available for improving facilities and productivity in primary agriculture, input supply, and storage, handling, and processing of food products. It will create a supportive policy and an institutional environment for market reforms in the rural economy, and strengthen Ukraine's ability to achieve the beginning of an overall economic recovery as a prerequisite for real restructuring of the food and agricultural sector.

Financing problems in Ukrainian agriculture: Diagnosis and possible solutions

LUDWIG STRIEWE, STEPHAN VON CRAMON-TAUBADEL, AND KONSTANTIN SIRIN

In Ukraine, agricultural enterprises depend almost exclusively on short-term external capital, while the share of bank credits in external financing is constantly shrinking. Input suppliers and the state remain the major lenders to agricultural enterprises. As of the end of 1999, the total debt of Ukrainian agricultural enterprises exceeded 15 billion hryvnias (around $3bn). While the debt burden is rather low by international standards, indebtedness remains a severe problem due to the low profitability of farms.

Agricultural enterprises are not able to attract needed external financing due to their low profitability, high production risks, lack of creditworthiness, significant transaction costs, and lack of collateral. However, the problem is aggravated by the weakness of the banking sector in Ukraine. In addition, the necessary institutions (including efficient bankruptcy and banking laws, bookkeeping systems, and the credit registry) are not in place. Consequently, in order to overcome financial problems in agriculture, Ukrainian government policy should address all these concerns.

"On the Establishment of a Credit System for Rural Estates in Mecklenburg" was the name of a competition organised by the Mecklenburgische Landwirtschaftsgesellschaft (Agricultural Society) in Germany in 1804. In this competition the Landwirtschaftsgesellschaft was looking for answers to two questions: (1) What are the obstacles to establishing a rural credit system? and (2) How might such a system be established? It took a couple of years before J. H. von Thünen, one of the founders of agricultural economics in Germany, won the competition with his analysis. He stressed that the main obstacle was not the lack of capital in rural areas at that time, but rather the uncertainty faced by lenders. Lenders lacked sufficient information on borrowers—they couldn't evaluate whether the borrowers' enterprises were profitable or not—and on borrowers' willingness to repay their loans. Hence, lenders couldn't assess borrower creditworthiness and this was, according to Thünen's findings, the main obstacle facing lenders who might otherwise be willing to supply credit.[6]

For the Ukrainian agricultural sector and rural Ukraine, Thünen's answer is still very relevant. Indeed, as will be argued below, it is not the lack of capital but the lack of creditworthiness that is the main obstacle to

[6] Cited in Neuberger, D.: *Johann Heinrich von Thünen als Förderer der Finanzintermediation* (Rostock 1997).

establishing sound credit relationships between farms and other enterprises in rural areas on the one hand, and potential lenders—a group that comprises input suppliers, banks and private money lenders—on the other. Other obstacles are shortcomings in the institutional framework that regulates the relationship between lenders and borrowers, and problems related to the Ukrainian banking system.

External financing of the agricultural sector in Ukraine: Current status and problems

In contrast to Germany, for example, where today roughly 85% of the agricultural sector's external financing is provided by banks and the rest through trade credits, the banking sector in Ukraine currently plays only a minor role in financing the agricultural sector. The Ukrainian banking system comprises the five successors of the large state sectoral banks, of which the most important for agriculture is Bank Ukraina, the former Agroprombank; in addition, more than 230 commercial banks emerged in the early 1990s, of which 176 survived until 1999 (see *Herald*, No. 3/99 –digest of the National Bank of Ukraine). However, most of the private banks have been financing the agricultural sector only to a very small extent, or not at all.

Who finances farms in Ukraine?[7]

Table 1 shows that agricultural enterprises (AEs) rely almost exclusively on short-term external capital and that the share of bank credits in external financing has been shrinking constantly. Indeed, it is negligible in the years after 1996. With respect to the shares of equity and external capital, the data have to be treated with care, with the assessment of farm assets being especially problematic. The book value of farm assets is derived from its purchase value minus a certain amount of depreciation. This often does not correspond to its market value, which is presumably much lower. Furthermore, the indexation of these asset values in times of high or even hyperinflation also leads to overvaluation.

The diminishing role of the banks can be explained partly by the reduction in state budget financing that was formerly channelled through the state banks. It is accompanied by an increasing role of direct state financing. As can be seen in Chart 1, in which the shares of total debt owed to different types of lenders is depicted, the share of debts to banks diminished to 3.1% by 1999, whereas the share of debt to the state increased to 38.2%. Given a total amount of AE debts as of December 31, 1999 at 15.2 billion hryvnias, the debts of the AEs to the state equalled 5.8 billion hryvnias.[8] Most of these government credits were never paid back, as some agricultural enterprises were unable to repay; moreover, some of the credits were misused.

[7] The analysis is based on the annual reports of the Ministry for the Agro-Industrial Complex, and, therefore, on the consolidated balance sheet for agricultural enterprises in Ukraine. It is clear that actually many agricultural enterprises, namely private/family farms and all subsidiary holdings, are excluded from this analysis, as no comprehensive data on them is available. However, there is evidence that the production of household plots relies to a large extent on inputs from former collectives, which can be seen as a form of external financing. Much of the high productivity of the household plots (they produce almost 60% of the gross agricultural output on 15% of the agricultural land) can be explained by their use of low-cost or free inputs from the former collectives.

[8] The figure includes tax debts and central fund payments, the latter being payments the state made through its government agencies that provide inputs to agricultural enterprises.

Table 1. Financing of agricultural enterprises in Ukraine

%

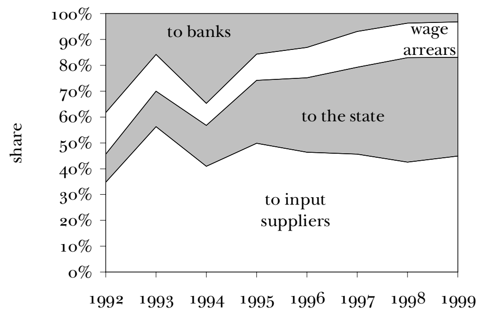
	1992	1993	1994	1995	1996	1997	1998
Equity capital in total capital	83.2	80.6	60.7	83.7	92.5	89.1	84.2
External capital in total capital	16.8	19.4	39.3	16.3	7.5	10.9	15.8
Short-term capital in total external capital	95.2	98.9	99.0	98.3	99.8	99.5	82.2
Bank credits in total external capital	38.3	16.0	35.0	16.0	13.0	7.0	4.0

Source: Ministry for the Agro-industrial Complex (1992–98): Annual Farm Accounting Reports, different issues. Own calculations.

The negative consequences of these high debts to the state are well known. In past years, the authorities have used draconian measures to collect their debts, e.g., they have confiscated grain or banned exports of grain and other agricultural products from certain regions. These measures have had adverse effects on the relationship between AEs and private input suppliers, as the latter were unable to collect payments or had problems exporting grain that they had received in payment for debt from the AEs.[9]

With the Law of Ukraine "On the depreciation of taxes and other dues" (No. 1565 dated 16.03.2000), all farm debts to the state were cancelled. Before and after the cancellation of these debts (especially after), private input suppliers have been and remain the most important lenders to the AEs in Ukraine. According to the data presented in Chart 1, their share in the total debt was roughly 45% by the end of 1999, with a total amount of claims on AEs at 6.8 billion hryvnias. After the cancellation of state debts this amount accounts for roughly 73% of total debt. The AEs' remaining debt is to their employees; this debt accounted for an almost constant share of 10–13% in recent years.

Chart 1. Shares of different creditors in total debts of Ukrainian AEs



Source: Ministry for the Agro-industrial Complex (1992–99): Annual farm accounting reports, different issues. Own calculations.

Debt burden of the agricultural sector

At first glance, the total debt burden of Ukrainian AEs appears huge. Including the now cancelled debts to the state, the value of all debts amounted to the total volume of goods sold by Ukrainian AEs in 1999. Even after the cancellation of the state debt, the remaining debt still amounts to roughly 8% of total Ukrainian GDP in 1999.

[9] This is explained in detail in the papers of the German Advisory Group on Economic Reforms in Ukraine I12, K1, K12, L38 and in von Cramon-Taubadel, S. and L. Striewe (eds.): *Die Transformation der Landwirtschaft in der Ukraine–Ein weites Feld* (Kiel 1999), chapter 6.

Is this debt burden too heavy for the AEs and is it high by international standards? In Table 2, the total debt per AE is calculated by dividing total debt by the number of AEs. The average AE had a debt burden of 1,236,700 hryvnias at the end of 1999, and this was reduced to 763,700 hryvnias by the cancellation of state debts. This amount corresponds to no more than the price of a Western-style middle-class combine.

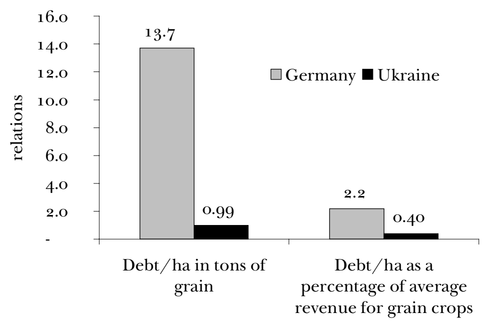
Table 2. The debt burden of Ukrainian AEs, per enterprise and per hectare, in hryvnias

	1996	1997	1998	1999
Total debt per AE	603,400	848,900	1,137,100	1,236,700
Remaining debt per AE without state debts	429,200	562,300	676,800	763,700
Total debt per hectares arable land	228	332	455	496
Remaining debt per hectares without state debts	162	220	271	306

Source: Ministry for the Agro-industrial Complex (1992–99): Annual farm accounting reports, different issues. Own calculations.

Of course, an enterprise's indebtedness cannot be measured by the volume of its debts alone. Instead, debts must be seen in relation to the enterprise's income-generating potential. Although there are some rather sophisticated measures for income generating potential, land is still the most-often used indicator, both for this purpose and for measuring the size of a farm. As the most reliable data available in Ukraine is on land use, we use arable land as a proxy for income-generating potential to compare the indebtedness of German and Ukrainian agricultural enterprises. To account for different product prices, indebtedness is converted into tons of grain, which is the most important arable crop in both countries (see chart 2). Moreover, to account for different yields per hectare, indebtedness on the right side of chart 2 is expressed as a share of average annual revenue per hectare (which is equal to the price multiplied by the average yield). Although it is clear that these comparisons use only an imperfect measure of the indebtedness of agricultural enterprises (in both countries the livestock sector is not taken into account), they offer some interesting insights.

Chart 2. Indebtedness of Ukrainian AEs compared to German farms (December 1999)



Note. We used the following data: grain prices–UAH500/t in Ukraine and DM250/t in Germany; average debt burden per hectare–UAH496 in Ukraine and DM3,429/ha in Germany; average grain yields–2.5 t/ha in Ukraine and 6.3 t/ha in Germany.

Source: Ministry for the Agro-industrial Complex (1992–99): Annual farm accounting reports, different issues. Own calculations. Bundesministerium für Ernährung, Landwirtschaft und Forsten (2000): Agrarbericht der Bundesregierung

First, note that the indebtedness per hectare in tons of grain is rather low in Ukraine compared to Germany, particularly since all debts—including the debts to the state that were recently cancelled—are taken into account in chart 2. Without these debts, the figure for Ukraine would be even lower, at just 0.61 t/ha. The same holds true for the debt per hectare figure measured in average revenues per hectare. Whereas a German farm would have to spend 2.2 average annual revenues to settle all debts, the average Ukrainian AE could settle its debts with just 40% of an average annual revenue (just 0.24 average revenues if the recently cancelled debts to the state are left out). If the farms only in Germany's New Federal Lands (these farms produce mainly arable crops and have average debts of 1,690 DM/ha) are considered, rather than the average for all of Germany, indebtedness expressed in revenues per hectare is 4 times higher than that of Ukrainian AEs.

Causes of the indebtedness of Ukrainian AEs

Even if the debt burden of Ukrainian AEs is rather low by international standards and compared to income-generating potential, the indebtedness of the agricultural sector remains a severe problem, because the low profitability of Ukrainian AEs (see table 3) indicates that few farms realise their income-generating potential.

Table 3. Profitability of Ukrainian AEs ranked by short-term solvency (1998)

ranking according to short-term solvency	Best	Second	Third	Fourth	Worst
short-term solvency coefficient*	2.3	5.0	8.1	12.9	61.7
profitability **	19	-6	-26	-53	-142

Note. **Calculated as short-term debt divided by liquid short-term assets.*
***Calculated as (total revenue–total costs)/total costs x 100.*

Source: Sedik, David: "Causes of Debt Accumulation and Low Productivity of Ukrainian AEs" in UAPP This Week in Ukrainian Agriculture, Issue 10(23), 6–12 March 2000.

Reasons for credit problems in Ukraine

As was shown above, banks play only a minor role in financing Ukrainian AEs. Furthermore, private input suppliers, who have claims of roughly 7 billion hryvnias on the AEs, have become very reluctant to finance Ukrainian AEs. A comprehensive analysis of the reasons for the insufficient external financing of the AEs has to cover all of the factors that affect the contractual relationship between lenders and borrowers. It is important that these factors go beyond the simple question of the supply of money for financing Ukrainian agriculture: "Finance is all about risk and trust, finance is not all about money".[10] In the following section a broad range of preconditions that are necessary for lenders and borrowers to come to terms is discussed.

Supply side of the credit problem

As shown in chart 3, the supply of credits by banks and other lenders depends on alternative investment opportunities, the quality of management, transaction costs, and

[10] v. Pischke, speaking at an 'Expert Meeting on Agricultural Finance and Credit Infrastructure in Transition Economies', organised by the OECD in Moscow (1999).

other factors such as the location of banks in rural areas.

Investment alternatives determine the interest rates which lenders are prepared to offer. If other investment projects are more attractive (higher expected interest rate and/or lower risk), lenders will be reluctant to finance agriculture. This aspect was of great importance for Ukrainian agriculture in the past, as their huge fiscal deficits that were largely financed by credits, government bonds, and T-bills led to a crowding-out effect.

Table 4. Interest rates and interest rate spreads in Ukraine

% annual rate

	1993	1994	1995	1996	1997	1998	1999
NBU refinance rate		222.6	128.4	62.0	24.6	61.0	50.4
Real NBU refinance rate		54.0	16.8	27.6	14.4	42.0	32.4
Commercial bank interest rates on credits*	183.6	249.6	126.0	80.4	49.2	54.0	55.2
Commercial bank interest rates on deposits*	158.4	208.8	66.0	33.6	18.0	22.8	20.4
Interest rate spread	25.2	40.8	60.0	46.8	31.2	31.2	34.8
Real interest rate on credits*	-250.8	81.6	16.8	44.4	39.6	36.0	37.2
Real interest rate on deposits*	-266.4	46.8	-38.4	-0.4	8.4	3.6	2.4

*Note. * Weighted average.*

Source: Ukrainian-European Policy and Legal Advice Centre (UEPLAC) (1999), p.50ff.

When interest rates of more than 80% were paid on government debt, much of the banks' credit portfolio flowed to the corresponding bonds and bills, leaving less than 50% of all bank credits for the non-state sector (36.2, 36.1, and 49.9% in 1995 to 1997, respectively[11]). This trend was not reversed until 1998, when roughly 80% of all bank credits were made available to the non-state sector.

The management of banks in Ukraine is another critical problem. As new credit technologies are not used properly and since internal structures are complicated and often inefficient, Ukrainian banks have problems, for instance, with the provision of micro-credits. Due in part to the inefficiency of Ukrainian banks, interest rate spreads in Ukraine are extremely high (see table 4).

Of course, the interest rate spread is determined not only by banks' cost structures but also by transaction costs in the banking business in general. These are high in Ukraine due to risk, particularly the risk of inflation. If poor macroeconomic conditions, for example high inflation, lead bankers to expect that the currency in which they provide credits could depreciate, they will attempt to cover this risk by demanding higher interest rates on credits or shortening the terms of the credits that they provide. Hence, exogenous macroeconomic conditions have a direct influence on the interest rates that lenders demand. It comes as no surprise, therefore, that in recent years Ukraine has seen inter-

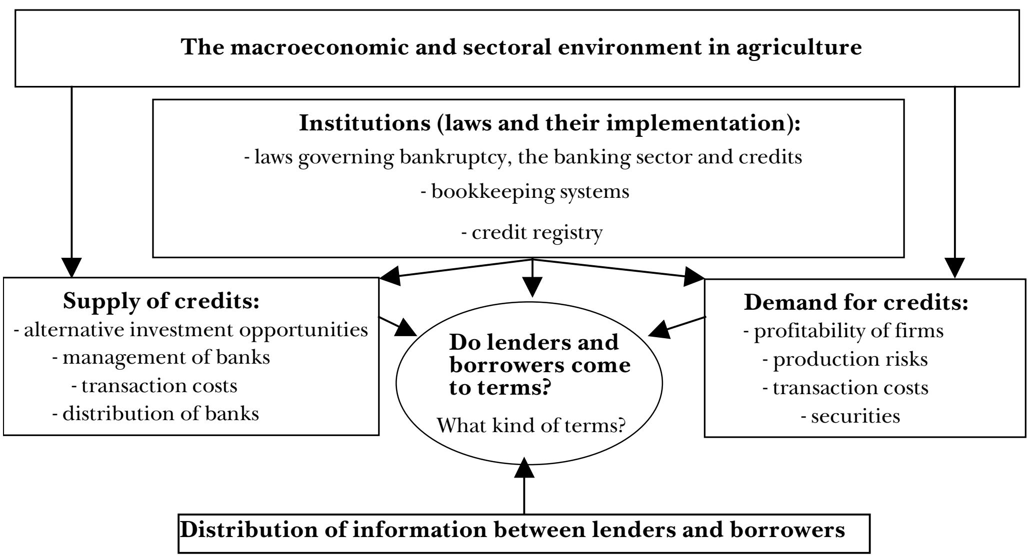
[11] Ukrainian-European Policy and Legal Advice Centre: *Ukrainian Economic Trends,* Quarterly Issue, September 1999, published by TACIS services DG 1A, European Commission (Brussels, November 1999).

est rates as well as interest rate spreads that are very high, even in comparison to other transition countries. As can be seen in Table 4, interest rate spreads in Ukraine have been consistently in excess of 30% in recent years. Between 1996 and 1998, real interest rates ranged from 36 to 44%.

In the past, numbers such as those just cited have been used to argue that problems on the supply side of the market for credits are the reason why farms in Ukraine are underfinanced. Of course, it is true that supply-side factors are of critical importance. Since long-run investments in particular will rarely have an expected profitability in excess of 30%, the fact that real interest rates on credits in Ukraine have been consistently higher in recent years suggests that the supply of credits for long-term investment projects in agriculture will be negligible.

However, supply-side factors alone are not enough to explain why there has been no supply of short-term credits to Ukrainian agriculture, especially to finance the purchase of inputs such as fertilisers and plant chemicals. The period between March–May, when key inputs are applied to crops, and July–August, when the harvest takes place, is only a few months. Over this period of three to five months, real interest costs of 9–15% are incurred in Ukraine. At the current, exceedingly low levels of fertiliser and plant chemical application in Ukraine, the marginal productivity of additional applications would be very high, and these applications would likely be profitable despite the high interest rates. The fact that short-term investments in basic yield increasing inputs nevertheless do not take place suggests that high interest rates alone do not explain the lack of credits provided to agriculture in Ukraine.

Chart 3. Determinants of credit relationships in Ukrainian agriculture



Source: Own presentation.

Another piece of evidence suggests that a shortage of funds and high interest rates alone do not explain the lack of credit provided to Ukrainian agriculture. Foreign banks that have considerable experience in agriculture - such as the German DG-Bank, the Dutch Rabobank and various international development banks - have, so far, been unwilling to lend money to Ukrainian agriculture. This despite the fact that these banks refinance themselves in hard currencies and, therefore, at much lower rates of interest. Even if it appears otherwise from a Ukrainian perspective, there is more than enough capital available in international markets to finance projects in Ukrainian agriculture.

However, rather than benefiting from net capital inflows, Ukraine and Ukrainian agriculture have witnessed net capital outflows in recent years. In other words, not only are Western banks and investors hesitant to invest in Ukrainian agriculture, Ukrainians themselves go to considerable length to take their capital out of the country rather than invest it domestically, for example in agriculture. No one is willing to invest in Ukrainian agriculture because the risk of non-payment is very high.

Demand side

The main reason why little capital is flowing into Ukrainian agriculture is depicted on the right side of chart 3. Along with the requirements that must be fulfilled on the supply side, certain requirements must be fulfilled on the demand side if lenders and borrowers are to come to terms. One necessary precondition is that agricultural borrowers—in other words farms—should be profitable or become profitable as a result of the planned investment. If this condition is not fulfilled, farmers will not be in a position to pay back any loans they receive and there is no reason why potential lenders should provide such loans.

Since it is known that roughly nine out of ten AEs in Ukraine are loss-makers, it is clear that this basic demand-side precondition is not met. The reasons for the lack of profitability are well known. Many AEs in Ukraine are horrendously inefficient. The productivity of labour on these farms is very low, due to the large amount of unemployment that is hidden on these farms. A further problem is the cross-subsidisation of household plots. Since most AE members are not paid in full or on time, many are given access to (or take) agricultural products or inputs as payment in kind. This access is often given at prices that are well below the market price of the products or inputs in question, which represents a significant drain on the farms' financial resources.

Another reason for the low profitability of farms in Ukraine is the inefficiency of the agricultural marketing sector. Numerous studies[12] have demonstrated that prices for inputs in Ukraine are much higher than on world markets, and prices for agricultural outputs are much lower.

Farms in Ukraine receive only a small proportion of the final price that consumers in Ukraine or in world markets pay for their products. This is largely due to the fact that many links in the marketing chain for agricultural products have not been privatised and remain highly inefficient. For example, loading grain from railcars onto a ship in a Ukrainian Black Sea port costs roughly 12 USD/t, almost twice as much as at other Black Sea ports. Such inflated marketing costs have the same effect as an export tax. Given that Ukraine—a relatively small country in the economic sense—is a price "taker" in world markets, inflated marketing costs are directly translated into lower farmgate prices. Other measures, such as the regional export bans that have been implemented following harvests of recent years, also act as indirect taxes on agriculture in Ukraine. By reducing farm profitability,

[12] See, for example, Sedik, D.J.: *Farm Profits and Agricultural Policies in Ukraine,* Iowa State University Ukrainian Agricultural Policy Project, Working Paper No. 8 (Kyiv 2000).

or von Cramon-Taubadel, S.; L. Striewe (eds.): *Die Transformation der Landwirtschaft in der Ukraine – Ein weites Feld. Wissenschaftsverlag Vauk* (Kiel 1999).

these factors also reduce their access to credit.

Beside the level of a farm's profitability, banks and other potential lenders will also be concerned about the variability of its profitability. Even if lenders expect that a farm will be able to repay its debts in an average year, they will not lend money to the farm if there is a high risk that repayment will not be possible in certain years. In this regard as well, Ukrainian farms are not attractive potential borrowers.

Furthermore, on the one hand, weather conditions are variable, leading to the risk of poor harvests in certain years. There is little that can be done about this source of risk, which is faced by agricultural producers all over the world. On the other hand, the Ukrainian government adds to the risk in the form of numerous, sudden, and unpredictable changes in policy. In recent years the government has resorted to regional export bans, the confiscation of agricultural products, export taxes on products such as oilseeds, and complex certification procedures such as those that were implemented in the fall of 1999 for grain. Whether or not and to what extent these measures were actually applied in practice, potential lenders are aware that such policy changes are especially likely in Ukraine. If the associated risk is too large, then they will refrain from lending to farms in Ukraine. At the very least, they will demand margins (interest rate spreads) that include a hefty allowance for political risk.

Transaction costs on the part of a borrower include all those costs incurred leading up to the signing of a loan contract. For example, a potential borrower must be in a position to make a loan application that includes realistic information on the liquidity and profitability of his enterprise before and after the proposed investment, including a realistic assessment of the risks associated with this investment. Not only does a business plan include information that is needed to assess the profitability of a proposed investment, it also signals that the responsible manager knows his operation and is able to manage it. Experience in Germany and other countries shows that potential lenders such as banks are not just on the lookout for good projects, they are also on the lookout for competent managers.

Finally, the collateral that a firm can offer plays a vital role in determining whether or not it is able to secure credit. Farms in West Germany, for example, have an equity ratio (the ratio of equity to the total value of all assets) of roughly 80% on average. Hence, these farms are, on average, able to use equity, such as land or machinery, to secure loans. If a bank believes that a farmer's equity is sufficient to cover the amount of a loan, and if the bank is assured that it will have a legal claim on this equity in the event that the farmer does not repay his loan, then the risk associated with granting this loan is reduced considerably from the bank's perspective.

In the new Federal Land of Eastern Germany, where roughly 90% of all land is rented and most farms have a correspondingly low equity ratio, access to credit is comparatively difficult. In many cases, farm managers have reacted by offering personal belongings (e.g., houses, cars) as collateral for loans. Even though the value of these personal belongings may be much smaller than the loans they are used to secure, in this way managers are at least able to signal to banks that their investment plans are well thought through and that they have every incentive to repay their debt.

Institutions

Even if all of the preconditions on the demand and supply sides of the market for credit in Ukrainian agriculture were fulfilled, it is not likely that many credit contracts would actually be signed. In other words, even if interest rates in Ukraine were much lower and farms were both profitable and able to provide securities, banks would still be hesitant to provide these farms with loans. The reason for this hesitation is that banks and other lenders are not in a position to enforce their claims on farms because the required legal instruments are missing. In chart 3, these instruments are labelled "institutions".

An important concept in this regard is that of the distribution of information, and the so-called information asymmetry. Note that the root of the word 'credit' (Lat. *credere*, to believe, to trust) indicates that trust is a key ingredient in the successful completion of credit contracts. It is difficult for banks in Ukraine to trust potential borrowers, because they are not in a position to judge whether these borrowers will be able and, most important, willing to repay. In other words, banks cannot judge the creditworthiness of potential borrowers. This is due to the following factors:

1. When judging a potential borrower's creditworthiness, banks find that farm financial statements in Ukraine are of little value. While these financial statements do include information on profits and losses in past years, it is well known that accounting practices and standards in Ukraine are riddled with weaknesses. Several examples of this were discussed above where we referred to official misrepresentation as well as forced and deliberate fabrication.

2. The prevalence of barter transactions in Ukrainian agriculture also makes it difficult for external evaluators to assess the actual profitability of a farm in Ukraine. It is often next to impossible to determine what prices underlie such transactions (e.g., when milk is exchanged for butter, which in turn is exchanged for shoes and, finally, diesel fuel, as one farm manager once explained to us), and often the same product is bought (or sold) at prices that can vary considerably depending on the market channel employed.

3. Even if it were possible to evaluate the profitability of a farm in the past (and the points made above suggest that this is not the case), future profitability would remain elusive. How an enterprise such as a farm will fare following an investment is difficult to answer even in Western economies under the relatively stable conditions prevailing there. In an economic environment such as that in Ukraine, it is essentially impossible to answer this question, especially if data from the past are unreliable.

All of this suggests that it is very difficult for banks to evaluate whether farms in Ukraine will be able to repay loans. A second, equally important aspect of creditworthiness is whether farms will be willing to repay. This is where the issue of information asymmetry arises. When a farm does not repay a loan, it is often difficult for lenders to determine whether this is due, for example, to a poor harvest because of bad weather or crop disease, or whether this is due to farm managers' hiding and/or farm members' stealing some part of the harvest, as is often reported. Of course, borrowers who do not repay a loan will always claim that it is due to bad weather or other unforeseen developments. In many cases, this will be true, but in others it represents fraud. An information asymmetry exists, because while the borrower is aware of the real reasons for his non-repayment, the lender is not aware and cannot determine the real reasons without incurring considerable expense, if at all.

Of course, banks and other potential lenders know that farm managers and the members of AEs in Ukraine have strong incentives not to repay loans. This will influence the banks' lending practices. In many cases, information asymmetry will lead banks to refuse to grant loans even to farms that appear likely to repay. Hence, information asymmetry, although it appears at first glance to be a problem faced by banks and other potential lenders, is really a problem for farms in Ukraine. Information asymmetry means that even farms both able and willing to repay cannot receive loans.

Market economies have developed a variety of institutions to combat information asymmetry. Many of these institutions take the form of laws that are designed to protect lenders, for example banks. These institutions include credit registries, transparent accounting systems, and bankruptcy laws.

In Germany, the Netherlands, and many other countries, households and firms can be identified as credit risks in a central credit registry. The principle behind these registries is simple. When a lending institution grants a loan to a borrower, it informs the credit registry of the identity of the borrower and the terms of the loan. In return, the lender can direct questions to credit registry and receive information on the borrower's credit history.[13] If a potential borrower has a bad credit record, the lender will be warned and can take appropriate precautions. Note as well that a central credit registry greatly increases the costs of non-repayment. Borrowers have a strong incentive to repay because they know that they will be listed as credit risks in the central registry in the event of default, and that this will make it much more difficult for them to secure loans in the future.

All steps that make it easier for lenders to evaluate the creditworthiness of their potential borrowers also contribute to a reduction of information asymmetry. A dependable and transparent system of accounting and financial statements is clearly of great importance in this regard.

Bankruptcy laws are among the most important institutions in the market for credit. By protecting lenders in the face of information asymmetry, bankruptcy laws increase the willingness of banks and other lenders to provide loans to agriculture. Therefore, rather than being seen as a threat, bankruptcy laws, as a precondition for providing credit to agriculture, are actually in the best interests of farms. The following parameters are key determinants of the effectiveness of a bankruptcy law: a) the criteria used to determine insolvency and trigger bankruptcy proceedings; b) the scope for negotiations and debt restructuring that can or must take place before a firm is liquidated; and c) the order in which various lenders enforce their claims.

Without going into detail on all of these points, recent experience in Ukraine demonstrates that the state has made extensive use of numerous tools (such as aggressive tax collection practices) to ensure that its claims receive preferential treatment. As a result, banks and other potential lenders are especially hesitant to lend money to any enterprise in Ukraine that has tax or other debts to the state (and this includes the vast majority of all enterprises, not just in agriculture).

According to experts, Ukraine's bankruptcy law is one of the best in the former Soviet Union (FSU). Hence, Ukraine does not need a new law but rather the will and the capacity to implement the existing law. Currently there is a moratorium on bankruptcies in agriculture until January 1,

[13] Of course, the protection of privacy is very important. Credit registries are only permitted to release information under highly regulated conditions. A borrower must be informed that the information he includes in his loan application will be made available to the credit registry, and he must grant a lender access to information on his credit history from the registry. A potential borrower can deny access to information on his credit history from the central registry, but it is clear that lenders will hesitate to lend money to such a borrower.

2004. It goes without saying that potential lenders will hesitate to provide credit to farms under these conditions. After all, why should they be willing to provide credits to farms that run almost no risk in the event of non-repayment? Hence, the moratorium on bankruptcy proceedings in agriculture, while it may appear to benefit individual farms, represents a tax on agriculture as a whole in Ukraine.

In this context, it is important to stress that the initiation of bankruptcy proceedings is not in the primary interest of banks. Bankruptcy proceedings are costly and often only lead to partial recovery of debts. Banks are generally interested in conventional repayment and in building long-term relationships with established customers. Banks prefer functioning bankruptcy laws because of their impact on borrowers' behaviour in an environment characterised by information asymmetry, not as a means of collecting loans.

Developing agricultural credit markets in Ukraine

Policy implications

Many of the preconditions and institutions that are required for the development of an efficient credit system for agriculture (Chart 3) are not fulfilled or available in Ukraine. One exception is Ukraine's banking laws, which are highly ranked in comparison to those in other countries of the FSU. The EBRD, for example, in a study of the depth and effectiveness of banking laws[14] concludes that the depth of Ukraine's banking laws can be ranked at 2.3 on a scale of 1 (bad) to 4 (very good). While some states in Central Europe receive a better ranking (for example Hungary, with a ranking of 4), Ukraine has one of the best ratings in the FSU.

However, the other prerequisites and institutions presented in Chart 3 and discussed above are not assured in Ukraine. Table 4 lists a number of policy measures that would create a positive environment for the development of an agricultural credit system in Ukraine. Using the scheme followed above, these are divided into measures on the supply side (banks and other lenders), measures on the demand side (farms and agricultural markets), and measures for the creation of institutions. As all of these prerequisites and institutions have been discussed above, there is no need for a detailed discussion of Table 4 here.

Note, however, that it would be unwise to focus exclusively on agricultural land when discussing collateral for loans. First, it is conceivable that banks and other lenders could be given a legal claim on future harvests that they could invoke in the event of non-repayment. Second, it is conceivable that borrowers could use personal belongings as collateral, as discussed above. Finally, so-called group credits could be used to provide banks and other lenders with collateral. In this case, several households or small firms join together to form a group and guarantee each others' debts. If one of the members of the group does not repay his debts, then no further credit is made available to any of the group's members. In this way the information asymmetry problem can be significantly reduced, because individual members will have an incentive to monitor each others' behaviour to ensure repayment and, if need be, to help each other out with this repayment.

[14] See the European Bank for Reconstruction and Development's 1998 *Transition Report*.

Table 5. Policy measures for improving the functioning of the agricultural credit market in Ukraine

Supply side Measures to increase the supply of credits	**Institutions** Measures for the protection of lenders' interests	**Demand side** Measure to improve the profitability of farms
1. General measures to strengthen the banking system: • reduction of inflation; • development of the market for collateral. 2. Increasing the efficiency of the banking sector: • development of new forms of securing bank loans; • use of micro-credit technologies; • restructuring of banks; • education and training of bank employees and regulators.	1. The implementation of international accounting and bookkeeping standards. 2. Implementation of a credit registry. 3. Lifting the moratorium on bankruptcy in agriculture. 4. Introduction of a legal framework for the use of mortgages.	1. Restructuring of AEs. 2. Increasing competition in the sectors up- and downstream from agriculture: • privatisation of state enterprises; • improving climate for domestic and foreign investors. 3. Liberalisation of agricultural markets: • elimination of trade restrictions; • elimination of barriers to trade within Ukraine; • elimination of all forms of price intervention. 4. Information and training for farm managers on the preparation of loan applications, financial statements, etc.

Source: Own presentation.

Effect of the role of the state on agricultural credit markets

In almost all countries of the world, some farmers (and entrepreneurs in other sectors) feel that their demand for credit at reasonable rates of interest is not satisfied. This often leads to calls for state intervention. It is interesting to consider what role the state can play in stimulating the provision of credits to agriculture. Three basic forms of state intervention can be identified: the direct provision of credit by the state, interest rate subsidies financed by the state, and credit guarantee funds. These three forms are discussed in turn below.

DIRECT PROVISION OF CREDIT. Many diagnoses of agricultural credit markets identify market failure, i.e., they conclude that for various reasons (e.g., the inherent risk of agricultural production) private credit markets will never provide the socially optimal amount of credit. Based on such diagnoses, analysts sometimes conclude that the state must directly intervene by providing credit to individual enterprises.

However, state intervention that is designed to counteract ostensible market failure must solve many difficult problems. Indeed, J. D. von Pischke stresses[15]: "... to the best of [my] ... knowledge, government or donor intervention motivated by the desire to overcome market failure in a developing or transition economy has never—never—produced a viable credit institution or program". The reason for this very pes-

[15] von Pischke, J.D.: "Preconditions for Sustainable Agricultural Finance and Credit Systems" in *Agricultural Finance and Credit Infrastructure in Transition Economies,* Proceedings of an OECD Expert Meeting (Paris 1999).

simistic conclusion is clear: state lending institutions must operate in the same environment as private institutions. While state lending institutions may be able to refinance themselves at lower rates (at the expense of taxpayers), they are nevertheless confronted with the problems of risk and information asymmetry that private lenders also face when dealing with agriculture.

Experience in countless projects in countries all over the world has demonstrated conclusively that the state is no better able to identify creditworthy borrowers than private lenders are. Moreover, state lending institutions are often under considerable political pressure to provide loans to loss-making enterprises. This has been amply demonstrated by the experience with state subsidies for farms in Ukraine in recent years. These subsidies, which have often taken the form of credits, have helped many AEs avoid necessary restructuring. As a consequence, they have fostered a highly irresponsible attitude towards debt repayment on the part of many farm managers, and they have fuelled large budget deficits in Ukraine, thus contributing to macroeconomic imbalance and, inter alia, high interest rates in Ukraine.

Interest rate subsidies. Interest rate subsidies have been demonstrated to be a very inefficient means of increasing the provision of credit to agriculture. In Germany, studies have demonstrated that there is no significant relationship between the provision of subsidised credits to farms and improvements in the efficiency of these farms. In many cases, interest rate subsidies have simply lowered the costs of loans that farms would have taken without the subsidy in the first place. Interest rate subsidies have also proven to be ineffective in many other transition economies because even at significantly lowered rates of interest, banks are still confronted with the problems of assessing creditworthiness in the face of asymmetric information. Interest rate subsidies in Ukraine cannot compensate for the fact that farms are not in a position to provide collateral, and that there is a moratorium on bankruptcy proceedings in agriculture. Because of these factors, banks are confronted with a significant risk of non-repayment, regardless of the interest rate they charge.

Credit guarantee funds. Lack of collateral is one of the major reasons why farms cannot secure loans. The moratorium on the implementation of the bankruptcy law, and various aspects of land laws in Ukraine, are at the root of this problem. However, even if these problems could be solved, some farms (e.g., those that rent most of their land) might face difficulties securing loans. Credit guarantee funds can provide a solution to these difficulties. Basically, a credit guarantee fund is an amount of money which the state provides as a "substitute" for the physical collateral that potential borrowers are unable either to offer or to offer in sufficient quantities.

There are examples of transformation economies in which credit guarantee funds have led to an increased rate of loan provision to agriculture and an increased rate of loan repayment. However, it must be stressed that the beneficial effects of credit guarantee funds are limited. Credit guarantee funds do not make farms more profitable per se, and they are no substitute for necessary restructuring. Moreover, credit guarantee funds can also have negative effects if they become too large or are extended to farms that are not creditworthy. In particular, credit guarantee funds can lead to a moral hazard problem if lenders, secure in the knowledge that the state is providing collateral, increase their propensity to finance riskier projects and/or borrowers. For this reason, relatively successful credit guarantee programs, such as the Rural Credit Guarantee Fund that operated between 1991 and 1996 in Hungary, only issued guarantees for a portion of the amount of the loans granted.

Oilseeds: A potential success story running the risk of policy mismanagement?

STEPHAN VON CRAMON-TAUBADEL AND LUDWIG STRIEWE

The Ukrainian oilseed industry has until recently been relatively successful, and managed to attract significant foreign investment. This suggests that the sector is internationally competitive and that policy distortions which have discouraged investment in other areas of agriculture have had a less damaging effect on oilseeds. Moreover, in the near future, the Ukrainian oilseed industry might benefit from the projected increase in world demand for oils and fats.

Meanwhile, current government policy is badly hampering the strengthening of the sector, which would allow Ukraine to tap into excellent export potentials. In particular, policymakers introduced an export duty on oilseeds. Such intervention is capable of eliminating any incentive for increased efficiency, and hence, the effects of this policy measure will be quite harmful for the international competitiveness of the Ukrainian oilseed industry. Moreover, Ukraine has already incurred a significant net welfare loss as a result of the export duty.

Ukraine is one of the world's major oilseed producers. Together with grains and sugar beets, oilseeds–in particular, sunflower seeds–are a pillar of Ukrainian crop production. While grain and sugar beet production in Ukraine fell by 52% and 65%, respectively, between 1990 and 1999, sunseed production fell by "only" 8%. Rapeseed production has increased significantly in comparison to other crops in recent years, albeit from an initially low level. These developments suggest that oilseed production in Ukraine has been less affected by the negative influences that have led to a collapse of grain and, especially, sugar beet production since the beginning of transition. Farmers in Ukraine have obviously decided to allocate scarce productive resources from other crops to oilseeds.[16]

The expansion of sunflower seed and rapeseed production in Ukraine since 1993 is primarily due to economic considerations and particularly the relatively high profitability of oilseed production in comparison to other crops. Ukrainian oilseeds are internationally competitive and, until recently, there have been comparatively few problems along the marketing chain.

Farms in Ukraine have not only been in a position to use the promise of future deliv-

[16] For a detailed analysis, see: von Cramon-Taubadel, S. and L. Striewe (eds.), *Die Transformation der Landwirtschaft in der Ukraine – Ein weites Feld* (Kiel 1999), Chapter 9.

eries of sunflower seeds to secure crucial inputs such as fuel and fertiliser, they have also been able to actually deliver the promised sunflower seeds to private input suppliers (who, unlike state input supply structures, have also been able to actually deliver the required inputs). Moreover, input suppliers could be reasonably certain (at least until recently) that they would be able to export any sunflower seeds they received in payment for inputs.

But in September 1999, the Ukrainian government imposed a 23% tax on oilseed exports. This suggests that policymakers in Ukraine were not satisfied with developments in the oilseed market and perceived a need to correct these developments. Since the performance of oilseed production in Ukraine was relatively positive, one might conclude that there is little need for policy intervention. As the saying goes, "If it ain't broke, don't fix it."

The whole story of the export tax seems even stranger, because the future of oilseed production in Ukraine looks promising as well: worldwide demand for oils and fats is projected to grow significantly in the near future particularly due to the increase in consumption in heavily populated countries such as China and India. Significant potential for increased demand also exists in Eastern Europe, as well as parts of Africa and Latin and Central America.

To meet the expected increase in world consumption of oils and fats, it would be necessary to increase oilseed acreage. Presumably it would not be possible to continue increasing oilseed areas worldwide, as has occurred over the last 10 to 15 years. Therefore, it appears likely that worldwide oilseed production would increase less rapidly in the future than it has in the past.

Altogether it can be expected that the competition between grains and oilseeds for scarce farmland would increase in coming years. If this forecast is accurate, then the prospects for Ukraine, as a country with a large agricultural area and untapped potential, are excellent. Assuming an area of between 2.7 and 3 million hectares for sunflower seed production and the 20–30% higher yields that could be obtained, it should be possible to generate significant profits for producers, processors, and exporters. Ukrainian producers could market a total sunflower seed harvest of 3.5–3.9 million tons at home and abroad without putting significant pressure on world market prices.

It is important to note, however, that the production and marketing of such a large sunflower seed crop could not be induced overnight, and certainly not if current agricultural and economic policies are maintained in Ukraine. It is not sufficient to merely appeal to Ukraine's large agricultural potential. Potential alone is worth little unless it is tapped properly. Indeed, some experts are of the opinion that an excessive preoccupation with the potential of Ukrainian agriculture has distracted the sector from the need to implement major reforms. Good soils are certainly not a sufficient condition for profitable agriculture, and experience in many countries that are less endowed with agricultural potential than Ukraine demonstrates that good soils are not even a necessary condition.

To become a global player in world markets for oilseeds and oilseed products, Ukraine will have to dismantle many barriers in the areas of production, processing, transport, and trade. However, in almost all areas, Ukraine's agricultural policy has so far created more problems than it has solved. These problems are sectoral and not product-specific.[17] An example of such policy action is the tax on oilseed exports, which is analysed below.

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[17] Since this issue has been discussed extensively elsewhere, it will not be repeated here. See, for example, ibid., chapters 1, 3, and 11.

A critical analysis of the tax on oilseed exports

In July 1998, presidential decree No. 755 stipulated that sunflower seed exporters must pay a deposit that would only be reimbursed after the corresponding export revenues had arrived and been duly processed in Ukraine. Before this decree could be implemented, however, massive protests by exporters, agricultural producers, and international donors led to its withdrawal. Further suggestions on how to control or limit exports were made in the following months, and on 12 July 1999, parliament passed a law calling for a 30% tax on oilseed exports. After a veto and negotiations between the parliament and President Kuchma, a 23% tax on oilseed exports became law in September 1999.

The export tax on oilseeds is very controversial. It is a major point of conflict with the IMF. Why has the government of Ukraine maintained this policy even though it threatens relations with the IMF? Three arguments that are often cited by Ukrainian proponents of the export tax are presented and analysed below.

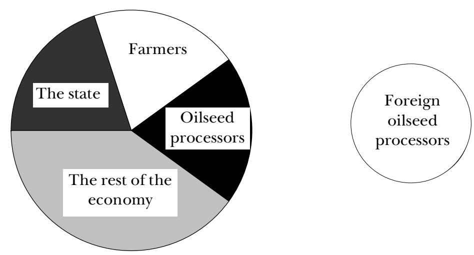
Argument 1:

Without the export tax, most Ukrainian sunflower seeds would be processed abroad. Ukraine ends up re-importing these sunseeds in the form of sunflower oil. Ukraine would be better off if the processing of sunflower seeds to sunflower oil–and the associated value-adding activity–took place at home.

This argument in favour of the oilseed export tax is cited more often than any other. In Chart 1, the basic idea behind this argument is presented schematically.

The large circle in chart 1 represents the total value-added of the Ukrainian economy; it occurs in agriculture, in the oilseed processing industry, and in other parts of the economy. The state secures a portion of this value-added via tax revenues and other activities. The small circle in Chart 1 represents the value-added that oilseed processing plants abroad generate using Ukrainian oilseeds. Proponents of the oilseed export tax argue that this tax has forced Ukrainian oilseeds to stay in Ukraine and be processed there, thus effectively shifting the value-added in the amount of the small circle in Chart 1, from foreign oilseed processors to domestic processors. In other words, these proponents argue that the oilseed export tax has shifted value-added that was taking place abroad into Ukraine, thus making Ukraine better off than it was.

Chart 1. Value-added in the Ukrainian economy prior to the implementation of the tax on oilseed exports

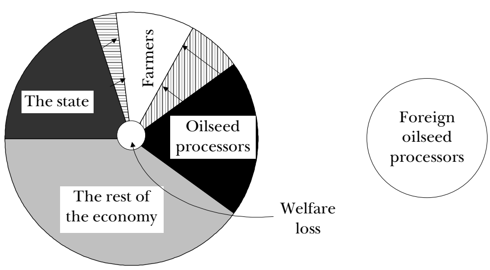


Source: Own presentation.

This argument is, however, based on an inaccurate view of how the economy works. Without the export tax, oilseeds are processed abroad because oilseed-processing plants abroad are much more efficient than those in Ukraine. If this were not the case, the Ukrainian oil processors would have no difficulty in outbidding foreign competitors for sunflower seeds produced in Ukraine. Furthermore, if Ukrainian oilseed processing plants were not less efficient, then their sunflower oil would have no difficulty competing with imported sunflower oil. Since this is not the case, Ukrainian oil processing plants are obviously not as efficient as their competitors abroad. This implies, however, that when a ton of sunseeds is processed in Ukraine, less value is added then when the same ton of sunseeds is processed abroad.[18] The argument that the oilseed export tax simply shifts value-added from abroad into Ukraine is therefore flawed.

The sunseed export tax, by distorting prices and incentives, forces value-added activity that would otherwise take place abroad to take place in Ukraine. As a result of these distortions, value is added in Ukraine, but less is added all together than would otherwise be the case. This is illustrated in Chart 2.

Chart 2. Changes and redistribution of value-added in the Ukrainian economy as a result of the tax on oilseed exports



Source: Own presentation.

The export tax leads to reduced sunflower seed prices in Ukraine. This, of course, has a negative effect on the producers of sunflower seeds (farmers). All other things being equal, the artificially reduced prices for sunflower seeds make sunseed processing in Ukraine appear to be more profitable. The oilseed processing plants in Ukraine profit as a result and their value-added increases, but it comes at the expense of the farmers who produce the sunflower seeds.

Hence, the oilseed export tax does not shift value added from abroad into Ukraine, but rather shifts value-added from Ukrainian farmers to Ukrainian oilseed processors. In Chart 2, this is represented by an increase in the share of the value-added circle that accrues to oilseed processors, and a corresponding reduction in the share that accrues to farmers. In Chart 2, we can also see that farmers lose a portion of their initial value-added to the state in the form of the export tax. Foreign oilseed processors are forced to use less Ukrainian sunflower seeds, but it is safe to assume that they will be able to secure enough raw material—sunseeds and/or other oilseeds from elsewhere—and that they will, therefore, suffer temporary losses at most.

Since the export tax was implemented, more processing has taken place in the less efficient Ukrainian oilseed processing plants. Therefore, as discussed above, less value is added altogether. Thus, the impact of the export tax is not limited to the transfers between farmers and processing plants shown above. Instead, Ukraine as a whole also suffers a net welfare loss. In other words, what farmers lose as result of the implementation of the export tax is not fully transferred to the oilseed processing plants and the state. These transfers are not perfect, but rather are accompanied by welfare losses, due to the inefficient allocation of resources.[19] As a result of the export tax, therefore, Ukraine's total value-added in Chart 2 is reduced by an amount that is

[18] In other words, producing one litre of sunflower oil in Ukraine uses more resources (especially energy, but also raw sunseeds) than the production of an equivalent litre abroad.

[19] See von Cramon-Taubadel, S. and L. Striewe (eds.), op. cit., Chapter 1 and, in particular, Box 1-7.

represented by the small circle labelled "welfare loss".

The various losses and transfers involved as a result of the sunseed export tax were estimated by the Centre for Privatisation and Economic Reform in 1999.[20] A 23% export tax would lead to a USD77m loss for farmers, and gains of roughly USD36m and USD40m for oilseed processing plants and the state, respectively. Depending on the length of the time horizon that is considered, the annual net welfare loss for Ukraine as a result of the oilseed tax varies between 1.2 and 9.5 million USD. Of course, in order to produce such estimates it is necessary to make many simplifying assumptions; hence, the results should be interpreted with caution. Nevertheless, they provide a reasonable estimate of the magnitude of the effects that the oilseed tax can be expected to have induced in Ukraine.

Argument 2:

Farmers do not suffer from the export tax because the state has directed its revenues from this tax back to agriculture. Hence, the export tax has helped oil-processing plants without harming any other group in Ukraine.

This argument is based on the idea that the state can use its revenues from the oilseed export tax to compensate farmers so that they would be just as well off after the implementation of the tax as they were beforehand. In the final analysis, therefore, the oilseed tax leads to a situation in which farmers and the state are just as well off as before, and the oilseed processing plants are better off.

Beyond the question of whether the state really has directed its revenues from the oilseed export tax back to oilseed producers, it is easy to demonstrate that this argument is invalid. First, it ignores the net welfare loss that was discussed above. Due to the net welfare loss, the export tax is not a "zero-sum-game"; some groups in the economy must be worse off after the tax is implemented than before. Furthermore, the state's revenues from the oilseed export tax are considerably smaller than the losses sustained by farmers, because the export tax only applies to sunflower seeds that are exported, while farmers suffer from lower prices on their entire harvest.

Argument 3:

Without the export tax, farmers in Ukraine would produce more sunflower seeds than is indicated by good agronomic practice. Hence, the export tax on sunflowers has led to a necessary reduction in the sunflower seed acreage.

The export tax on oilseeds has been defended by government officials as necessary to keep farmers from producing sunflower seeds too frequently on the same acreage. Even if it is true that the current crop rotation is too "tight" (it is generally recommended that sunflower seeds not be sown more frequently than every 7–8 years on the same acreage), this argument is highly suspect. Are we to believe that bureaucrats in Kyiv know more about farming than practitioners in the countryside in Ukraine? Are farmers in Ukraine so poorly trained or so inexperienced that a paternalistic state must intervene to prevent them from hurting themselves?

The answer to these questions is, of course, no. Farmers are well aware of the risks associated with producing sunflower seeds. The fact that they are prepared to run the risks associated with a tight sunflower seed rotation is no argument for increased state intervention but is rather an indication of just how damaging Ukraine's ill-advised agricultural policy has been to date. It also reflects the fact that the expected profitability of

[20] See Center for Privatization and Economic Reform, *The Economic Effect of Export Duties on Ukrainian Sunflower Seeds*, Iowa State University's Ukraine Agricultural Policy Project, Occasional Paper No. 17 (Kiev 1999).

other crop activities, such as grain or sugar beet production has, until recently, been very low.[21] In other words, agricultural policy in the years since independence has left farmers with no alternative but to farm in a way that is not consistent with good agronomic practice. Rather than reducing the profitability of one of the few remaining profitable crops for farmers in Ukraine, policymakers should concentrate on reducing the distortions that make other crops unprofitable.

The real reasons?

The driving force behind the implementation of the export tax for oilseeds is the oilseed processing industry, which has engaged in intensive lobby activity in Kyiv. This is a perfectly legitimate activity in a democracy; various groups have the right to articulate their interests and to try to convince policymakers to implement measures that further these interests. If economic policy is to be successful in the long run, however, it cannot be focused exclusively on serving partial or sectoral interests. Attempts to stimulate the economy by means of special subsidies and support for individual industries will only lead to a heavy burden of direct and indirect taxes for the economy as a whole, and less, rather than more, economic activity altogether overall.

In the case of the tax on oilseed exports, there is reason to believe that the interests being served are especially partial. Only a few oilseed processing plants are responsible for a large proportion of the oilseed processing in Ukraine.[22] Of these, still fewer have the resources required to purchase sunflower seeds; many of the other plants are not in a position to increase their capacity utilisation, even at the lower sunflower seed prices brought about by the export tax. This suggests that the benefits of the oilseed tax are concentrated on a select few oilseed processing plants. Specifically, experts point to the processing plants in Dnipropetrovsk, Poltava, and Polohiv (Zaporizhia oblast) as well as a new facility in Donetsk.

The fundamental problem with most oilseed processing plants in Ukraine—and this is a problem shared by the agricultural processing industry in general—is that they are not internationally competitive. A future-oriented policy must be primarily concerned with correcting this lack of competitiveness, and not simply disguising it at the expense of other sectors of the economy.

The competitiveness of the Ukrainian oilseed processing industry can only be improved with the help of investments and modern technology. High prices for sunflower seeds are not the main barrier to such investments. On the contrary, sunflower seed processors in other countries operate profitably on the basis of sunflower seed prices that are higher than those prevalent in Ukraine. The main barrier to investment is a problem that affects not only the oilseed processing industry but actually just about every branch of the Ukrainian economy—that is, the poor investment climate in Ukraine. Plans for the construction of new oilseed processing fa-

[21] In 2000, the profitability of grain production increased considerably as Ukraine moved from an export to an import situation. If the next grain harvest is as good as is currently expected, Ukraine will return to an export situation and grain prices can be expected to fall significantly. Hence, the current profitability of grain production is likely to be short-lived and the argument made above remains valid. For a detailed discussion of grain markets and grain market policy in Ukraine see von Cramon-Taubadel, S., *After Decree No. 832: Grain Market Policy in Ukraine,* German Advisory Group Paper O11, December 2000.

[22] For a more detailed discussion, see: von Cramon-Taubadel, S. and L. Striewe (eds.), op. cit., Chapter 9.

cilities and/or the modernisation of existing facilities in Ukraine are locked away in the desks of competent and well-financed firms around the world. However, these plans, and the promise that they represent, will remain locked away as long as the conditions for domestic and foreign investment in Ukraine are not improved.[23] The export tax on sunflower seeds is an expensive medicine that merely treats the symptoms of a much more serious disease. Other transformation economies, such as Poland and Hungary, have been much more successful at combating this disease, because they have concentrated on fighting its cause rather than doctoring its symptoms.[24]

Future prospects

Ukrainian agriculture could participate in and benefit from the increase in worldwide demand for agricultural products that is expected in the coming years. The potential growth in demand for oilseeds—particularly sunflower seeds and rapeseed—is especially large. The combination of Ukraine's comparative advantage and increasing worldwide demand and prices is especially promising.

Before the export tax on oilseeds was implemented, oilseed production in Ukraine benefited from the fact that it seemed to be largely ignored by policymakers. The development of oilseed production prior to the implementation of the export tax demonstrates that private input supply and output marketing structures can be much more effective than state structures. The central government's withdrawal in 2000 from input supply activities in the agricultural sector of Ukraine is a positive step which indicates that policymakers have learned this lesson.

The abolition of the export tax on oilseeds would represent an additional positive step. In 1994 a consultant team in Ukraine wrote the following: "Two years ago, the World Bank already saw the comparative advantage of sunflower production in Ukraine. Despite recently reduced yields, the comparative advantage holds true. The only way Ukraine could lose its comparative advantage in sunflower growing is because of political decisions..."[25] Unfortunately, it appears that the reservations expressed by these consultants was realised in the form of the export tax.

[23]Ibid., Chapter 3.

[24]Note that oilseed processors in Ukraine would also benefit from improved access to imported sunseeds and raw oil (in other words, a reduction of tariff and non-tariff barriers). This would enable them to improve their capacity utilisation in the summer months prior to harvest. At the moment, reduced tariff rate quotas are distributed periodically, but in a very ad hoc manner that is not transparent and probably associated with extensive rent seeking.

[25] *Final Report,* Gesellschaft für Agrarprojekt mbH, Ukraine Edible Oilseed Processing Project (Hamburg 1994).

Ukrainian sugar: Developing an industry restructuring policy plan

Frank Bostyn and Andriy Boytsun

The Ukrainian sugar industry has declined sharply over the last decade. In general, the industry cannot withstand competition in the world market, both in terms of quality and price, and hence, the whole sector needs redressing. From an economic point of view, the straightforward answer would be to discontinue growing sugar beets altogether; however, at social and political level, the immediate social fall-out in terms of layoffs looms large. Pressure from within is high to keep sectors artificially going with heavy state intervention and subsidisation, but that kind of solution is not sustainable in the long term. Nevertheless, the government has continued to apply mainly ad hoc measures to artificially support the sector, while a long-term strategy is still missing. A successful long-term strategy should include measures aimed at ensuring efficiency at both macro- and micro-economic levels, while also addressing social problems.

Ukraine's sugar industry is confronted with tremendous problems, the nature of which is not unique. The breakdown of the Soviet Union and the disintegration and reform of the economy meant also the loss of the traditional market for Ukrainian sugar. The real reasons are not political, but purely economic: Russia, the main importer of Ukrainian sugar, now has a wide opportunity to buy for better terms in the world market. This observation points immediately to the heart of the matter—structural competitiveness in the Ukrainian sugar sector.

From an economic point of view, the solution would be very straightforward: stop growing and refining sugar. The challenge remains huge, however, at the social and political level; the immediate social fall-out in terms of lay-offs looms large. Hence, seemingly sound economic policies are confronted with the insurmountable challenge of making them politically acceptable.

This kind of problem is not new to history. Many have lived through the shutdown of coalmines, steel mills and shipyards in Europe, the sanitation of textile industries in Belgium, etc. There are basically two questions that have to be answered in this regard:

1. what is the future of the sector (i.e., can it be/become competitive), and
2. what policy measures should be taken to turn the sector around or even to shut it down, without social outburst and with an efficient transfer of labour into other sectors.

Many transition economies are facing problems of this nature in defining industrial policies. Pressure from within to keep sectors going artificially with heavy state intervention and subsidisation is high, but that kind of solution is not sustainable in the long term. It also justifiably upsets international financial institutions. Apart from the fact that it cannot be a real solution to the problem, it might disrupt the whole transition process. The extent of the restructuring challenge is so broad that even a minor level of subsidisation leads to structural budget deficits, putting any serious attempt of macroeconomic stabilisation at risk.

However, neither will simplistic solutions do the job. Immediate and unconditional shutdown of a whole industry might be a convincing solution on paper, but cannot be expected to be manageable in reality. Governments thus need well-balanced policy schemes which effectively lead to the sanitation and redressing of the sector, while also dealing with reconversion.

At the same time, these schemes must be convincing and acceptable for the main international financial institutions. Relations with these important players should not be disturbed, because the transition economies are mostly—and hopefully only for the time being—quite dependent on their support. Also, any policy scheme for industrial restructuring would most probably need input from those institutions and/or from the wider donor community, which is usually very sensitive to the opinion of the international financial institutions.

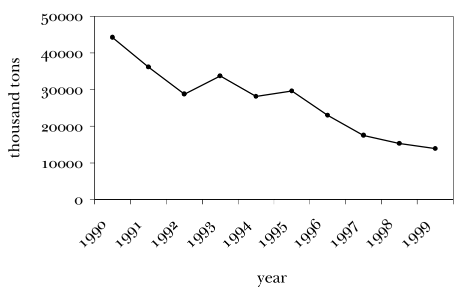
Ukrainian sugar industry: Decline and decay

Performance

Beetroot production in 1999 was 13.9 million tons, which amounts to only 31% of the 1990 output. Productivity (i.e., yield) has been falling significantly and now is at less than half of the world average and about a third of the productivity in Europe; in 1999, yield was 15.9 tons per hectare (against 18.7 t/ha in 1998 and an average 26.5 t/ha in the 1986–1990 period). Area under beetroot shrank to about 900,000 hectares in 1999. Interestingly, the first signs of decay in the sector showed long before 1990, which means that the transition is in no way the single factor causing the decline.

Sugar production fell correspondingly, from 2 million tons in 1998 to 1.86 million tons in 1999. The production of sugar from beetroot was 1.65 million tons (1.88 million tons in 1998); the rest of the production accounts for sugar processed from raw cane sugar. Simple calculations show that despite the decline in beetroot sugar, a trend for increasing production from raw sugar has emerged in the past few years.

Chart 1. Beetroot production in Ukraine in 1990–99.



Source: Ministry of Economy of Ukraine.

Many representatives of the sugar industry would claim that Ukraine has a good tradition of producing sugar and is capable of producing as much as 6 million tons of this commodity a year. However, this only represents the industry's technical capability, and the underlying economic question—whether the sector is competitive—is ignored. A broader screening of the strengths and weaknesses of the sector is summarised in the table below.

Table 1. Strengths and weaknesses of Ukraine's sugar industry

Strengths	Weaknesses
Sugar beet production	
1. Good natural potential: • Large area of rich soils available for sugar beet production; • Sufficient climatic conditions (up to 160 days in the south); • Favourable geographical location between East and West. 2. Sufficient labour resources. 3. Large and undivided arable areas.	1. Lack of an appropriate input base (chemicals, transport, machinery, etc.) 2. Unaffordable prices of agricultural machinery (combine harvesters) 3. Obsolete and worn-out irrigation system, half of which is more than 20 years old. Unsatisfactory privatisation in irrigation. 4. Insufficient storage facilities on farms. 5. Lack of monogerm seeds. 6. Lack of knowledge, experience and education for profitable private farming. Needs for management and marketing skills. 7. Lack of financial and managerial experience needed for the new market economy conditions. 8. Absence of organisational background for professional and inter-professional nongovernmental producer associations on national and regional levels. 9. Feed production not related to animal husbandry needs.
Processing	
1. Large number of suppliers. 2. Evenly distributed processing capacities linked to railways. 3. Capacities have good growth potential. 4. Qualified personnel with a longstanding professional tradition.	1. Current over-capacity, obsolete equipment at the refineries. 2. Barter and illegal transactions caused by refineries' indebtedness, not allowing them to show any funds in their accounts. 3. Excessive energy consumption. 4. Currently, insufficient demand from the confectionery industry. Lack of up-to-date technologies and equipment for small and medium-sized confectionery enterprises. 5. Continuous lack of working capital. 6. Insolvency throughout the industry. 7. Lack of investment.

Strengths	Weaknesses
Market and sales potential	
Domestic market	
1. Good domestic market coverage: baked goods, brewery, spirits, and feed milling.	1. Uncompetitive cost of sugar as compared with the world market price.
2. Promising domestic market for the confectionery industry.	2. Actual monopoly on sugar refineries: most refineries are subordinated only to the former state committee Ukrtsukor. Domination of new cartels in the industry.
Export market	
1. Long-term relations and good possibilities with Russia and other FSU countries.	1. Severed links with FSU partners at the official level; shrinkage of exports to Russia.
2. Interesting prospective markets in Middle and Far East.	2. Underdeveloped trading infrastructure, especially for export.
	3. Quality grading inconsistent with international standards.
	4. Lack of export credits or guarantees.
State policy in the sugar sector	
1. Privatisation. Transitioning from the inefficient control and command system towards more efficient self-organised free-market management.	1. Continued government support to the sector. Indecision regarding the shutdown of inefficient enterprises.
	2. Unfinished privatisation and incomplete farm restructuring. Lack of a legislative, organisational, and financial background to complete the restructuring successfully.
	3. Inappropriate privatisation policy for the processing industry.
	4. Lack of a comprehensive or consistent price policy.

Source: Bostyn, Frank (1997), Strategy paper on market and price policy for Ukrainian Agriculture, Tacis FD UK 9301 – Agricultural Policy Advisory Service.

From this, sustainable competitiveness is not apparent. Stefan von Cramon-Taubadel[26] conducted a thorough analysis of sugar production's competitiveness. His conclusions are very straightforward and do

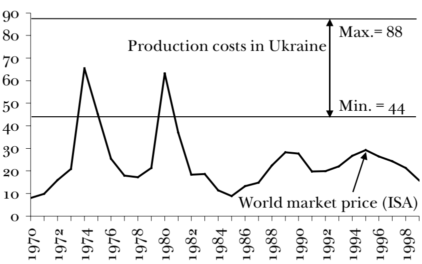
[26] See von Carmon-Taubadel, Stefan, "Der Markt für Zucker in der Ukraine: Gestern, Heute und Morgen", in Stefan von Carmon-Taubadel & Ludwig Striewe (eds.), *Ein weites Feld: Die Transformation der Landwirtschaft in der Ukraine* (Göttingen 1999)

not provide an optimistic view for a sustainable future for Ukraine's sugar industry.

One reason is that Ukrainian sugar is of poorer quality and does not comply with international standards. The other, more important reason is price. Ukraine's sugar industry[27] has much higher costs, resulting from two major factors: (1) beetroot sugar is generally less competitive than cane sugar, (2) the country's sugar production is inefficient.

Chart 2. World price for white sugar and production costs of sugar in Ukraine

US cents/kg



Source: S. von Cramon-Taubadel, "Der Markt für Zucker... ".

Note: ISA is the International Sugar Agreement, which was adopted under the auspices of UNCTAD in 1992 and entered into force in January 1993. One of the objectives of ISA is to collect statistical information, perform its analysis, and publish sugar-related information. In particular, the ISA price is a very important reference for sugar specialists. For more information, see http://www.isosugar.org/.

The inefficiency of Ukrainian sugar refineries is caused by a number of factors, such as input supply problems, poorer technical capabilities and outdated equipment of the refineries, lower sugar content in beetroot, lower sugar extraction, etc. Another factor is the small capacity of most of the refineries, further increasing their average production costs. However, even though the capacities are small, they are underutilised (average capacity utilisation is less than 50%); also, due to energy supply problems, the period during which sugar is produced is unreasonably long (about 80 days). Combined, these factors contribute to the extremely high cost of Ukrainian sugar and lead to a huge difference in the cost of Ukrainian sugar and world prices.

As illustrated in Chart 2, the average world price for sugar is around $220/tonne, while Ukrainian sugar producers claim that their costs are much higher and, therefore, insist on a minimum price covering those costs.[28] The state gave in and set minimum prices for sugar at 2,000 hryvnias per tonne.[29] This decision was, in fact, a follow-up to the earlier Law "On the state regulation of sugar production and sales", which has further complicated the situation in the industry.[30]

Some aspects of the current government policy in the sector

It may seem that the Law "On the state regulation of sugar production and sales" is aimed at reducing the number of producers and thus improving their capacity utilisation, but a closer look shows that the effective objective is absolutely not in line with realistic economic goals. The law provides for quotas A, B, and C. Quota A is the limitation on sugar produced domestically

[27] Ukraine has 192 sugar refineries, most of which are loss-making.

[28] See, for example http://www.ukrsugar.kiev.ua; last accessed on 30 June 2000.

[29] About $360. See Resolution of the Cabinet of Ministers "On certain issues of state regulation of sugar production and sales" (No. 868, dated 2 June 2000).

[30] Adopted on 17 June 1999.

for the domestic market (currently set at 1.5 million tons), Quota B is for sugar exported under intergovernmental agreements, and Quota C is the rest of the sugar produced and destined only for export. Those entitled to Quotas A and B enjoy guaranteed sales at guaranteed prices.

The authors of this system claim that this is exactly the way sugar market is regulated in the European Union when surplus produced sugar is exported. However, there is a serious difference between the two: the European Union subsidises exports, thus maintaining the balance in the industry, while Ukraine does exactly the opposite by only subsidising the production allowed for the domestic market. As a consequence, the law sets an oligopoly of producers who have dominated the industry.[31]

Therefore, the law is aimed at reducing the number of producers and thus improving capacity utilisation, but not on a competitive basis. Those privileged producers with direct access and impact on the decision makers get the Quota A, but they are not necessarily the most efficient or viable ones.

This law creates no incentives for the industry. On the contrary, it reflects a major backtrack of Ukraine's policy, because cost-based pricing and guaranteed sales are pretty much the same as the state order. What is even worse, the social effects—which have been so much advocated by industry spokespersons—are not taken into account at all. This policy does not solve the actual problem (i.e., improve the efficiency with mitigation of social effects). On the contrary, it does not necessarily even improve the efficiency of the privileged producers, but liquidates—without differentiation or consideration for economic viability—the other two-thirds of the refineries, without mitigation of social effects.

Apart from the fact that this policy is not really addressing the issue of effectively redressing the sugar industry into a viable, competitive, and sustainable sector, it has at least two other negative outcomes: (1) social discontent resulting from the deteriorated conditions at most factories (or their shutdown) is highly possible, and (2) domestic consumers will be paying much more for sugar. Not only will consumers pay more, the sugar market can now be manipulated more easily. Ukraine already experienced sugar market deficits, distortions, and illegal imports in June 1999 and June 2000, which were caused by market agitation resulting from traders trying to artificially increase prices immediately before the sugar refining season starts. Ukraine is also now importing white sugar, not only raw cane sugar as it did before. Then again, if the state policy was to secure market stability and guaranteed satisfaction of domestic demand, these market distortions should have been pre-empted.

One can wonder why there is still a market deficit, with all the support of the government and the capacity to produce enough sugar at home. One of the reasons is the country's policy with respect to agricultural imports. The current import duty imposed on raw sugar is 50% of the customs value; it makes it more expensive than sugar produced domestically and thus prevents raw sugar imports. However, this is another example of the short-sightedness of the policy: in the short run, the government helps sugar refineries withstand market pressure, but it ruins the industry in the long run

[31] Production and price formation in Ukraine's agriculture is generally distorted by the existence of monopolies. Even though regulation updates have tended to liberalise the market through so-called free prices and less control, monopolies still seem to be intact and remain close with the administration. Beyond the obvious distorting effects on competition, monopolies are obstacles to modernisation and therefore to productivity improvement, as well as subsequent price moderation within a free competition network. This essentially resulted from privatisation taking place without prior dismantling of the former state monopolies.

(since sugar refineries' capacities are underutilised, but capacity utilisation could be improved due to raw sugar imports) and makes domestic consumers poorer by forcing them to pay a higher price for sugar. [32]

The need for a long-term vision

Sugar beet production is Ukraine's traditional agricultural commodity, and was part of the industrial revolution in agriculture at the end of the 19th and beginning of the 20th century. Today, the world's technology of sugar refining has advanced and mostly turned towards cane sugar processing. In addition, the broken links with former Soviet Union partners and the failure of the former "state order" system have prevented Ukraine from maintaining its sugar production levels. In this context, Ukraine has very few trump cards to compete with in the world sugar market, or even in sugar-beet production against European producers, except for cane sugar processing.

The Ukrainian sugar industry has two major economic problems: high costs and unfavourable market conditions. The economic goal, therefore, must be to decrease the price and the costs as much as possible, mainly by a better organisation of the sector on the basis of its comparative advantages. This would lead to a significant shrinkage of the sector. However, instant shutdown of many refineries would in fact mean the loss of jobs for many people, because the refineries actually represent whole towns where most of the population is employed at the refineries. Thus, the situation represents a huge practical problem and a nearly impossible political challenge.

Up to now, the government has offered only short-term solutions to the immediate needs of the producers, and recently, as discussed above, a structurally ill-conceived industrial policy. A long-term vision which would take into account the fundamentally changed conditions has never existed. The government has been implicitly prolonging the suffering of sugar refineries by providing massive support to the industry. On the one hand, it would not let enterprises go bankrupt; on the other hand, the efficiency of the industry has constantly fallen.

One reason for this may be that the government was willing to support the lingering factories because it did not want to lose domestic production of sugar as a strategic product. Another may be that it was afraid of possible social outbursts. In any case, this intervention has always been short-term, because nobody seems to have bothered with long-term restructuring. A third reason, however, is probably that the government has often been the target of lobbying by interest groups, such as major sugar producers and their associations, who have demanded special treatment for the industry. This has also contributed significantly to the short-term (and, therefore, destructive) nature of the interventions, because this lobbying has often been individual.

Therefore, there is a growing need for a long-term vision for the Ukrainian sugar sector. A sound strategy for the industry should be developed, taking into account both macroeconomic conditions and industry-specific problems, as well as political and institutional constraints, also including the delicate relationship with international financial institutions, as indicated above.

In the following box, we propose a general outline for such a policy plan, very much inspired by the design of Belgium's former textile restructuring policy. Possible application of such a methodology to developing a restructuring plan for Ukraine's sugar industry is given after the box.

[32] In the past few years, though, the government has adopted ad hoc resolutions for every season, allowing duty-free raw sugar imports in the amount necessary to offset the sugar deficit in the domestic market. The most recent example is a resolution allowing the import of 260,000 tons of raw sugar at a duty of *euro*5 per ton.

Methodology for developing a sectoral restructuring policy plan

Application of proper methodology is crucial for developing an effective long-term industry restructuring policy plan. The methodology we offer basically consists of the following three elements:

1. *Identification of economic problems in the troubled sector;*
2. *Definition of policy objectives; and*
3. *Development of policy measures.*

1. Identification of the economic problems of the troubled sector

Problem-identification should focus only on the economic issues at this initial phase, in order to get a clear idea on the long-term determinants of sustainable solutions.

The focus on the economic aspects only is the best guarantee to come to sound solution design with a perspective on long-term sustainability and health of the sector, with only a reasonable burden for the state budget. Social issues and consequences will be plugged in later and are thus not neglected by such an approach, on the contrary: by stressing the economic viability of the solutions, the Government is laying the proper foundations for the development of decent and sustainable social conditions and well-being. ("You cannot build a social paradise on an economic desert!").

Useful problem indicators are:

- *Competitiveness (production costs and production quality internationally compared, efficient links into the international markets, etc.);*
- *Financial situation (debt/equity ratio, profitability, free cash flow, etc.)*
- *Technical and managerial conditions.*

The problem-analysis should be centred around the following fundamental questions:

- *Is there any way a future for the sector can be ensured, based on a fully competitive and open market economy, without state intervention?*
- *If yes, what are the structural adjustments needed to reach this position?*
- *How can the state support the efforts made by the private sector to reach this position?*

In case there is no real future for the sector that makes any economic sense, then the only option is to close down this line of economic activity. The government can take several positions to bring this about or to do the opposite:

- *Non-intervention while enterprises are going in liquidation or even bankruptcy (which in this case is a sound process of economic sanitation of the overall economic structure of the economy);*
- *Soft intervention with a scheme for mitigating the social consequences and for promoting labour reconversion (this is a reasonable political option in case the sector is very important in the current economic structure of the country or is heavily concentrated in a certain region; a good example is probably the mining sector);*
- *Heavy intervention with a view of maintaining the activity or, so to say, fading it out at a very gradual pace. That is what the government, without being explicit on the matter and probably without proper consideration and deliberation, is currently doing in the sugar industry. This option is extremely costly, most harmful for the economic development of new sectors and hence for the renewal of the economy. It will typically prolong economic hardship and social pain, and does not, in the end, solve the real problem, i.e. that the sector has no future and will continue to destroy economic value-added. When pursued on a broad base, covering an important percentage of the economic activity of the country, it is a good recipe for accelerated impoverishment of the country.*

For all the proposed measures, the economic implications, especially the budget consequences, should be well analysed in advance. It is only by doing that, that one can fully assess the viability and economic *soundness of the proposed measures, and that one can be in a position to oversee the global package of measures and decisions needed to make the policy effective (legislative initiatives, budget decisions, implementation resolutions and orders, etc.)*

2. Definition of the policy objectives

The policy objectives must be clearly defined and well-communicated. They will be concentrated around three topics:

- *The industrial or sectoral objectives: structural adjustment needed, ideal industrial organisation (competition, minimum efficient scale, domestic value-added, specialisation, domestic and international market channels, etc.);*
- *The economic viability of the enterprises: financial redressing of the companies, sound financial structure (debt/equity ratio, free cash flow, long term profitability, etc.), healthy cost structure, high capital productivity, sound management and good technical base, proper corporate governance and effective ownership, strongly developed marketing function, etc.;*
- *The social objectives: appropriate employment level, high labour productivity, social accompanying measures, etc.*

The compatibility of the objectives should be checked as well as the possibility, especially in terms of burden on the budget, to pursue them all at the same time. Hence, it is advisable to define their order of priority: (a) this should not be counter-productive for the economic viability of the scheme and from the point of view of sound public governance, and (b) often it is best to do this in a discrete way to avoid political commotion which may put the fundamental guidelines of the scheme at risk, because of short-sighted political claims based on narrow group interests.

3. Policy measures: mechanisms and management

The design of the policy measures is probably the trickiest thing, as to a large extent it will determine the effectiveness and the ultimate impact of the scheme. There are five focal points which should be well-considered:

- *the nature of the policy measures and the types of supportive interventions;*
- *the allocation of financial resources;*
- *the legal base and framework for the policy scheme;*
- *the institutional framework for the implementation of the scheme; and*
- *the management of the policy scheme.*

Especially the last two are extremely important for a successful implementation, as they deal with the real implementation decisions and have to tackle and anticipate the entailed risk for deviation from the set objectives, corruption or improper use of resources.

The nature of the policy measures and the types of supportive interventions

Typically, the economic and industrial objectives will be attempted by conditional, financial support measures and by business, management, and marketing consulting services, while the social objectives will be subject of accompanying reconversion and social safety net measures.

Targets for the conditional, financial support will typically be:

- *new investment projects to structurally improve the standing of the enterprise;*
- *broad financial restructuring to redress the debt/equity ratio and the working capital position; and*
- *investment in working capital, accompanying an enterprise restructuring scheme, an investment project or a new business plan/strategy.*

The most important financial criteria for the conditional, financial support should be:

- *the economic viability of the proposed project and/or strategy;*

- *the right to control the use of the allocated resources during the implementation of the project supported by the policy scheme;*
- *the temporary nature of the financial support (firm commitments and enforceable obligations to return the allocated financial support, proper assessment of the repayment capacity of the enterprise for the assumed debt and obligations);*
- *effective ownership by the shareholders, sound corporate governance mechanism, effective corporate control over the management – all this might possibly entail changing the ownership structure (consolidation of shares into larger groups and promoting effective outsider control); and*
- *possibly, the involvement of outside investors and complementary commercial bank investment loan.*

Financial instruments that can be used should be clearly defined and very well secured. Possibilities are equity participation, interest subsidy, low interest loan, and hybrid financial instruments.

The service complement of the policy scheme can entail consulting support in defining an enterprise restructuring strategy or assessing an investment project, training and advice regarding the strengthening of the marketing function, a sector-wide marketing plan to promote the product nation-wide as well as internationally, etc.

The allocation of financial resources

Proper financial resources have to be made available for the implementation of the scheme. Several considerations should be given:

- *How much financial resources are necessary to achieve an effective impact in terms of supporting the private sector to improve its performance in a sustainable way?*
- *How should the resources be made available? From a direct budget allocation or by means of a loan from an International Financial Institution? This question is related to the management challenges involved in such a policy scheme. It is advised to involve the international financial institutions in it to have better guarantees for sound management of the restructuring fund and the policy scheme.*

The legal base and framework for the policy scheme

The executive body for the policy scheme must have a clear legal mandate, with well-defined responsibilities and control mechanisms. All proposed interventions must have an explicit legal base and the financial instruments must be legally secured. Normally, a whole set of legislative acts and implementation resolutions should be developed and approved.

The institutional framework for the implementation of the scheme

The executive body for the implementation of the scheme should be set up on a clearly defined and legally based mandate. It is imperative that the decision-making is fully and integrally delegated to such a body, which should be completely independent of politics and the administration. The better option, in line with the suggestion to involve the international financial institutions in the funding, is to have an important participation of international experts. Effective control mechanism and responsibilities should be defined as to ensure that the decisions made and the approval of investment dossiers is exclusively based on the inherent, economic soundness of the proposals. In case the Government also decides to complement the financial measures with a package of support services, additional institutional arrangements might be necessary.

The management of the policy scheme

The rules of the game should be clearly defined in a transparent way and effectively communicated to all involved. Transparency is often the best guarantee for objective decision-making. Realistically speaking, this will probably necessitate the involvement of management consultants at the level of dossier preparation and the involvement of international experts in assessing the proposals and the implementation capacity of the enterprise and its management. Principles of the modus operandi, which have been proven to be very effective are:

- *selectivity: "back the winners";*
- *project-oriented approach, instead of company-oriented;*
- *minimal financial support as to increase the commitment of the shareholders and the management;*
- *temporary nature of the support;*
- *complementary nature of the financial support;*
- *secured controllability.*

It is also important that no adjustments, which are not in line with the original policy scheme, are admitted. Ukrainian policy-making has a very rich tradition of ad hoc interventions (e.g. granting privileges to specific enterprises) spoiling the originally flawless scheme. For this purpose, independent and strong management of the policy plan, increased openness and lack of secrecy in its implementation are crucial.

Possible sketch for Ukraine's sugar sector

Applying the approach described in the box above would lead to a sound policy outline that is effectively tackling the real issues, while also opening some perspectives on agreement with and support from the international financial institutions and the broader donor community. This moral and financial support is deemed to be very important for the success of these major restructuring challenges. Especially the rulings regarding institutional arrangements and transparency of the policy and its implementation are crucial aspects in sound policy design and for convincing the international community.

As we concluded earlier, even though the industry is technically capable of producing this much of sugar, it is (a) loss-making, (b) unable to compete with other world's producers, and (c) unable to compete with other Ukrainian industries, since opportunity costs in other industries are lower.[33] Hence, the questions that should be put on the government's agenda, are as follows:

1. Is the sector worth restructuring?
2. What should be the restructuring policies?
3. How can the government mitigate social effects and facilitate re-employment?

The amount of sugar produced in Ukraine roughly equals domestic consumption, but the industry is loss-making and the only obvious way to improve its efficiency is to let the most efficient refineries produce the amount of sugar needed. According to many estimates, including those by Ukrtsukor,[34] 45 refineries would suffice for that purpose. The production would be much more efficient, since (a) the most efficient refineries would stay in the sector, (b) their capacities would be fully utilised. If the industry gains momentum in the future and is able to produce more sugar on a competitive basis, whether from domestically grown beetroot or from imported raw sugar, then it can increase production, but without any government intervention. In political terms, this means that most Ukraine's sugar refineries (some three quarters of them) should be shut down.

[33] Simply speaking, the land, human and technical resources used for sugar production in Ukraine can be used for alternative purposes, which would result in creation of a greater value added.

[34] *Ukrtsukor* is Ukraine's National Association of Sugar Producers. The association was established on the basis of the former Sugar Committee, a government institution responsible for sugar production planning and control. The association still performs many functions of that committee.

With this answer to the first question, whether it makes sense to restructure the sector, the policy objectives as defined earlier should be:

- to reform the industry so as to achieve its efficiency and competitiveness,
- perform microeconomic restructuring (i.e. ensure economic viability of the refineries), and
- solve resulting social issues.

The objectives must be clearly defined and communicated to the major players in the sector. These are the oligopolies, whose objective is to maintain and strengthen their position in the market, the farmers, who are forced to grow beetroot and thus prevented from alternative uses of their limited resources, and the labour force employed in the sector.

The answers to the second and third questions, i.e. how the restructuring should be performed and how negative social effects should be offset, are discussed below.

Industry restructuring policy

While developing a restructuring policy, economic efficiency, profitability, and competitiveness of the sugar industry should be recognized as the ultimate economic objective. After all actors recognize that, any measures preventing the achievement of this objective should be recognized as inappropriate. The government should also pay attention to the following issues:

- Industry restructuring should be fully in line with macroeconomic policies of the government. The development of the industry is dependent not only upon the industry-specific policies, but, to a great extent, on the macroeconomic policies. Thus, for example, favourable investment and tax policies, as well as small and medium enterprise development, are crucial.
- All government policies, both macroeconomic and industry-specific, should be predictable because investors and market participants are primarily interested in the stability of terms and conditions rather than specific terms and conditions themselves.
- Restructuring policies must facilitate a conversion of the production towards a more efficient and cheaper technology based on processing raw (cane) sugar. This will contribute to the efficiency of the economy in two ways: (1) by allowing sugar refineries to achieve better capacity utilisation, (2) by allowing for alternative use of land, human and resources by industries where Ukraine has better comparative advantages and where opportunity costs are lower.

Since competitiveness is the ultimate objective, free market policies should be pursued. True market management in the subsector must lead to the following measures:

- Any government support and interventions should be reduced to a minimum, if not fully ceased. The government should: (1) refrain from fuel and input supplies to refineries, (2) stop forcing the farmers to grow beetroot. As a result, only those having access to credit, i.e. viable enterprises, will stay in.
- Market actors should have the freedom to produce and sell beetroot and sugar, as well as process raw cane sugar. In this respect, quotas and minimum prices must be lifted.
- Import policies should be liberalized significantly: import duties should be either reduced to a minimum.
- Transport of the beets from one rayon to another, as well as between oblasts, must be made free. Consequently, there will be absolute freedom for a sugar beet producer to sell his own crop to the sugar refinery of his choice. The same

applies to sugar refineries, which will be free to purchase the beets for processing anywhere.

- Therefore, no monopolistic position in the sugar industry should be tolerated. Any other measures obstructing free market polices should be rejected.
- The industry is highly dependent on the adjacent factor markets, such as the market for land and labour. Land should finally become private property and the land market should be liberalized.[35]
- As regards labour, free movement of labour should be enabled. Today, many administrative barriers prevent this ('propyska', registration with local polyclinics and military commissariats, etc.; see below).
- A market cannot effectively function without market infrastructure and institutions supporting it. Hence, government policies should foster the emergence of such a market infrastructure. Relevant institutions supporting the market and protecting the legal rights of its actors should be set up.
- This industry allows for large farms. Growing and selling sugar beet does not tolerate improvisation. Farms should use appropriate seeds, inputs, and agricultural machinery, as well as minimize sugar beet losses during harvesting. For that, farmers – more than in many other sectors – need strong representative organization to negotiate with industrialists.
- Where necessary, and otherwise impossible, the government can provide credit to prospectively viable enterprises. However, this should be done through commercial banks with banks bearing the commercial risks. The banks can assess the business/restructuring plan and make the decision.
- In all instances of government procurement, the government should pay in cash. This will create competition amongst prospective contractors who are willing to work for cash payment and disable corruption.

Market strategy of sugar producers

Sugar producers will, naturally, have to reconsider their market strategies, if the above policies are pursued. If no guaranteed sales exist, the refineries will have to adapt their production to the changing environment. When doing so, they will have to identify domestic and neighbouring markets and consider technological changes necessary to achieve their competitiveness.

In general, there is a good prospective for sales in the domestic market, since white sugar is difficult to transport and its storage is expensive, and therefore it make sense in many cases to make it domestically. Ultimate consumers of sugar are not only individuals, but also food industry (bakery, non-alcoholic beverages, brewery, spirits, and feed milling). A very important consumer is confectionery. Ukrainian producers also have good chances in Middle and Far East markets, such as the former Soviet republics in Asia. However, this requires that the sugar can be sold at competitive prices.

Obviously, the producers will not be able to avoid changes in technology. The two directions, in which the industry will have to change, are (1) development of raw cane sugar processing, and (2) production of sugar substitutes.

Ukrainian refineries are already processing cane sugar. This mostly happens when market deficit occurs in late June (before

[35] This matter is beyond the scope of this article; it is considered in this issue of *Policy Studies* by Csaba Csaki and Zvi Lerman.

the production season in Ukraine begins) and the government adopts a special resolution allowing duty-free raw sugar imports. This pattern has occurred for at least a few consecutive years, and the amount of raw sugar necessary to cover the deficit has been growing every year. In 2000, it was 260,000 tons.

In most cases, the leading actors of the Ukrainian sugar market imported raw sugar. Others are not strong (or not rich) enough to react instantly to the government resolutions: This kind of resolutions is considered as an ad hoc measure and imply that raw sugar be imported within a few days. Consequently, quotas for such imports are given to those who have their ships ready, i.e. the richer or informed ones.

A third of Ukrainian refineries are equipped to process raw sugar, while the rest of the refineries could enable such processing by introducing reasonable technological changes. However, raw sugar imports are generally too expensive (except for imports within the mentioned special resolutions). The duty to be paid in case of raw sugar imports is 50% of the customs value. These imports should be liberalized and, ultimately, raw sugar should enter the Ukrainian market duty-free.

Another supporting argument for raw sugar processing is that neighbouring Russia and Belarus are already exporting (though, often illegally) white sugar processed from raw sugar to Ukraine's eastern regions. This does not only prove that (since traditional producers of beetroot sugar are implementing the new technology) technological changes in sugar production should be finally taken into account. It also means that Ukraine can no longer maintain the costly beetroot sugar production, and no administrative measures will help the country do that in the long run.

Another prospective niche for Ukrainian sugar refineries is the production of sugar substitutes (isoglucose, inulin and high-fructose maize syrup). They are not traditional for the Ukrainian market, but already widely popular in the North America, where their consumption roughly equals a half of total.

It may be argued that the average Ukrainian will not immediately adapt to consuming substitutes instead of "real sugar", but industrial consumers of sugar, especially the food industry, could easily introduce respective changes in their technological processes.

Moreover, if Ukrainian refineries do not introduce the production of cheaper sugar substitutes today, there's a serious threat of further loosing market share to competitors. Since sugar substitutes do not fall within the current quota regulations, they will freely enter the Ukrainian market and thus indirectly limit the consumption of white sugar produced in Ukraine.

The only option the government will then have is to introduce even heavier intervention by setting high tax rates for such imports, introducing quotas for sugar substitutes, or doing both. In other words, the very same problem may recur in a not too distant future. Ukraine's sugar industry will then remain uncompetitive, loss-making and burdening for the government budget. The Ukrainian consumers will keep on paying more. This is another proof that current policies, which arguably support the industry in the short run, definitely destroy it in the long run and are harmful for the whole economy.

Social issues

Industrial social conflicts have typically occurred not only as a result of shrinking production. They have often also been caused by technology growth and improved efficiency, which decreased the need for labour. In this sense, the social issues are a special part of the industrial restructuring plan, and deserve special attention. As we mentioned before, the solutions for social problems should only be considered after economic priorities have been defined; otherwise, the seemingly successful short-term decision may eventually result in major disasters. If underlying economic problems are solved successfully, they can be a foundation for building up social welfare, not otherwise.

In management of social conflicts resulting from industrial restructuring, the goal is generally threefold:

- to achieve consensus for restructuring;
- to enhance the social protection of the workers involved; and
- to boost their chances for re-employment.

As regards achieving consensus, we think it is most important to start an open discussion at every level involved. The question will basically boil down to gaining the acceptance for essential restructuring by those involved: (a) associations representing the industry (such as Ukrtsukor and its regional subsidiaries), and (b) the workers of sugar refineries. However, as we stressed earlier, it is crucial that openness and transparency of such a discussion be guaranteed. In addition, once consensus has been achieved and the decision to restructure the industry has been made, workers should be warned; this will allow them to plan their actions long in advance.

The questions that will have to be taken care of thereafter are (1) social protection of released workers, (2) possibilities of their alternative employment, and (3) re-adaptation of production in the troubled regions.

In **SOCIAL PROTECTION,** the following instruments, mostly aimed at labour conversion, should be considered and implemented (as long as they fall within the agreed budget limits):

- early retirement (and associated temporary allowances);
- tide-over allowances;
- compensation for loss of income;
- relocation expenses (to encourage geographical mobility);
- compensation payments; and
- training allowances.

ALTERNATIVE EMPLOYMENT in Ukraine, though not only for the sugar refinery workers, is contingent on two major factors, which actually go beyond the industrial restructuring plan: development of small and medium enterprises (SMEs) and reducing barriers to workforce migration.

If the government policies promote SME development, it will be much easier to alleviate the social tension. Analysing this issue is beyond the scope of this article. In this context we will only mention that sugar refinery workers have relatively better chances than workforce in Ukraine's other unrestructured sectors (such as steel, coal or energy) because their labour skills here are relatively less unique, and thus allow for more flexible employment.

Workforce migration should be eased. Many administrative barriers currently prevent it: "propyska", registration with local polyclinics and military commissariats. Propyska is a local residence permit. Every Ukrainian national should have a permit to reside in a specific place. The current law regards permanent residence in a different place, or residence without a permit at all, as a serious offence. In addition, without having a propyska (or having a propyska in a place different than the place of his/her actual residence), a citizen or his family cannot enjoy many social services such as health care, education, etc. Changing propyska often constitutes a problem because the applicant must provide sufficient reasons to substantiate his application.

Polyclinic is an institution where the population can get medical assistance, in most cases for free. If the individual has no propyska in that area, he/she must pay for all services he could otherwise receive for free. Besides all that, able-bodied male population is registered at local military commissariats and can be convened in case of military danger. All this immobilizes significantly the labour market. Reform in this area should start by abolishing propyska.

RE-ADAPTATION OF PRODUCTION IN THE TROUBLED REGIONS in the case of the sugar sector, again, can be handled relatively easier than in others, since sugar production, unlike coal and steel for example, is not concentrated in a specific area of the country. On the contrary, sugar refineries are scattered across Ukraine. This, however, does not mean that regional problems will not occur. Yet, abandoned areas will be smaller. Towns, in which sugar refineries are located, normally depend on them; however, this does not make the whole region such as oblast dependent on those refineries. Thus, workers can find alternative employment in neighbouring areas relatively easier. Exceptions are, probably, Vinnytsia, Cherkasy and Sumy oblasts, as well as Khmel'nyts'ky oblast and the south of Kyiv oblast.

To solve this problem, proper regional development policies should be elaborated. Regions should be given more independence. This, on the one hand, will create more freedom for the regions, but, on the other hand, will also shift part of the responsibility for the restructuring to regional governments thus ensuring wider involvement. The government should foster the development of regional development associations. Again, SME development should receive special attention, since this can promote the development of the new, market-oriented, structure of those regions.

Such social policies will definitely require certain budget spending. However, we are sure that this spending will be no more than spent today on subsidizing the industry. On the other hand, current policies do not in any way solve the problems—they only aggravate them and perpetuate the need for state support—while sound restructuring policies only require spending at the initial phase and will result in industry's efficiency and alleviated budget burden.

P.S. — A brief overview of recent policy developments

All the articles in this issue of Policy Studies were prepared in the summer of 2000; therefore, most references to data and other publications are dated before July 2000. Due to the heavy overload of *Policy Studies* in recent months, they could not be published earlier. Nevertheless, the arguments, and most forecasts, remain valid.

Ukrainian government policy in agriculture has generally improved over the last half-year, which has been reflected in the reduced input supplies to the sector, orientation towards private farming, and deregulation of the commodities market. Despite the entrenched resistance of interest groups to such policy measures (for example, in the form of arbitrary restrictions on grain trade at the local or oblast level), we consider this to be a positive change, which will help to revive agriculture in Ukraine over the next few years. The outcomes remain to be seen, but they will definitely affect the issues raised in this publication.

In farm restructuring, most of the issues discussed here remain unresolved, due to contradictory legislation. Part of the problem is that the Presidential Decree "On immediate measures to accelerate reform of the agricultural sector of the economy" (No. 1529/99 dated 3 December 1999) is in conflict with laws adopted both previously and subsequently. There has been no certainty on whether land share certificates can be used in lieu of land titles (aka, state deeds of the right to land ownership). Moreover, recently the Ukrainian Parliament adopted a law banning the purchase-and-sale transactions in land certificates allowed earlier by the abovementioned decree.

At the legislative level, this problem could be solved through adoption of the Land Code, which has so far passed first reading in Parliament.[36] In addition, there exists little support for the land reform process in terms of institutional framework.

As regards the financial problems of Ukrainian agriculture, a legislative solution has not yet been agreed upon. The law "On mortgage" has not been adopted yet.[37] The moratorium on bankruptcy of agricultural enterprises is also one of the major handicaps preventing effective development of the sector, as hard budget constraints and strict financial discipline cannot be applied to farms. An important positive development, however, is that the Parliament recently cancelled the *Kartoteka-2* regime, which sanctioned the unappealable seizure of funds from corporate bank accounts by the state.[38]

Earlier, the Ukrainian government also made a number of moves[39] to reduce inter-

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[36] Since this happened in July 2000, the draft Land Code is not discussed herein.

[37] The draft passed first reading on 5 October 2000.

[38] See the Law "On the procedure for redeeming taxpayer debts owed to [state] budgets and targeted funds".

[39] See Cabinet of Ministers resolutions "On new approaches to supplying agricultural producers with inputs" (17 January 2000) and "On additional measures for crediting spring fieldwork in 2000" (25 February 2000), Presidential Decree "On the creation and functioning of an agricultural market" (6 June 2000), etc.

vention in the sector and help create market relationships in it. However, no real market relationships can be expected until the land market problem is resolved properly. One of the consequences is that investment in Ukrainian agriculture remains low.

The tax problem also remains unsolved, largely hampered by the continuing failure of the Parliament to adopt the new Tax Code.[40] Conflicts of interest prevent stability and predictability of tax legislation in Ukraine. In particular, the attempt of the President to restore collection of the VAT from agricultural enterprises has met with strong resistance from the Ukrainian Parliament, which had introduced a moratorium on VAT payment for agricultural enterprises.

A number of solutions to these problems, as well as to some of those discussed in the article on farm restructuring and land reform, is offered in the draft Law "On stimulation of the development of agriculture for the period 2001–2004", which is being considered by the Verkhovna Rada. The measures suggested by the document include effective protection of property rights, development of a market infrastructure, establishment of an agricultural credit system, etc.[41] It remains to be seen, however, whether the law will be adopted in its current edition. Besides, an institutional framework to support these solutions is as essential (if not more so) as the law itself, but hardly any measures have been taken to set up this framework.

Another continuing problem is the much-debated 23% export duty on sunflower seeds, which has not been rescinded. It appears, moreover, that it has not played the moderating role it was supposed to play. As everyone involved in the debate remembers, one of the most important arguments of advocates of the export tax was that it would help reduce the area sown under sunflowers so that "sound agronomic practices" could be complied with. Recent developments show clearly that this is not the case. Ukraine's record crop of sunflower seeds in 2000 was due to increased yield, while the area under the crop remained at precisely the same level as a year ago (2.89 million hectares).

We believe that sunflower exports for MY'00/01 will be comparable to the MY'99/00 levels. Exporters have often resorted to loopholes such as the notorious "give-and-take" (in-kind tolling payment) scheme to effectively export sunflower seeds on a duty-free basis. All this, in turn (as microeconomic theory would predict), will mean a welfare loss for the economy. In addition, the current debate on the sunflower export tax in the Verkhovna Rada has simply postponed a large part of the exports, not restrained them.

Finally, the sugar problem in Ukraine has perhaps remained as acute as it was. Beetroot production declined further, by over 6% in 2000 compared to 1999. This will lead to a decline in the production of beetroot sugar. Exports have declined, and imports of both raw and white sugar have increased (white sugar imports increased about tenfold against 1999); the same developments are expected in 2001. As acknowledged by all sugar specialists, the recent regulations related to sugar production and sales, including Cabinet of Ministers Resolution No. 868 "On certain issues of the state regulation of sugar production and sales" (dated 2 June 2000), which are criticised in this issue, have not worked.

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[40] The Tax Code was adopted in first reading back in July 2000.

[41] On the other hand, full-scale implementation of the measures suggested by the draft would create a serious burden on the government budget. For a concise overview, see *Quarterly Predictions* #13.

In addition, as is forecasted herein, Ukraine has been facing the competition of its neighbours, Russia and Belarus, whose markets it was supposedly going to conquer with its beetroot sugar. The issue of illegal trafficking remains unresolved. As we had predicted, more control in related areas has been imposed (e.g., stricter controls over sugar imports and pricing, minimum prices for beetroot, on-site "tax posts" of the State Tax Administration at enterprises, etc.). Once again, the Parliament was forced to reschedule the debts of sugar refineries until 2004, but it has not bothered to address the real causes of the problem. Thus, the criticisms regarding the lack of competitiveness of Ukraine's sugar industry have become still more relevant. And, therefore, the structural approach suggested herein is more topical than ever.

An important change compared to all previous seasons is that 46 sugar refineries out of 192 did not operate this year, which is a logical agony rather than the result of a sound restructuring policy. It is thus essential that the Ukrainian government should realise this and refrain from further "perfecting" the sugar legislation, as currently suggested by advocates of the quota system.

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Address of the International Centre for Policy Studies:
8/5 Voloska St., Kyiv 04070, Ukraine

Tel. +380-44-463-6337. Fax +380-44-463-5970.

E-mail: mmax@icps.kiev.ua Web: www.icps.kiev.ua

For more information on subscribing to this and other ICPS publications, please contact Oleksii Blinov at marketing@icps.kiev.ua, tel. +380-44-463-6337.

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